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NAVAL POSTGRADUATE SCHOOL

Monterey, California



THESIS

OPERATIONAL AUDIT MODEL FOR A SMALL
NOT-FOR-PROFIT ORGANIZATION

by
Johnnie Johnson III

June 1980

Thesis Advisor:

R. T. Harris

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Operational Audit Model for a Small
Not-for-Profit Organization

by

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Lieutenant, Supply Corps, United States Navy
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Submitted in partial fulfillment of the
requirements for the degree of

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June 1980

ABSTRACT

This thesis examines the need for better management tools and techniques for managers of small not-for-profit organizations. It discusses the impact, purpose and size of the private not-for-profit sector. An argument is made for the need and application of an operational audit for small not-for-profit organizations, and discussion given to specific benefits to be derived by managers whose organizations are examined by an operational auditor. Intergrating the special needs and considerations that must be contemplated before intervening into a small not-for-profit organization, a model is designed for assisting small not-for-profit managers. Once the model is outlined, the author demonstrates the usefulness of the model by applying the model to a real small not-for-profit institution. Concluding that an operational audit provides managers with a tool which allows them to be better managers.

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I. INTRODUCTION

A. GENERAL

The economy of the United States can be viewed as composed of three principal sectors. The private for-profit sector, the public (governmental) sector, and the private not-for-profit sector (Weisbrod, 1978). The thrust of this research effort will concentrate on the private not-for-profit (NFP)¹ sector which is commonly referred to as the nonprofit or voluntary nonprofit sector.

The private sector is characterized by organizations with an objective of making a profit. In this paper, they will be often referred to as private enterprises or businesses. This private sector, sometimes referred to as private business sector, can be further divided into big business and small business. An example of large business would be Sears, Xerox, IMB, etc., and an example of small business would be independently owned family restaurants, service stations and retail operations.

The public sector is composed of governmental owned and/or operated municipalities, state and federal agencies. Also classified as part of the public sector is that group of

¹NFP refers exclusively to the private not-for-profit sector for the purpose of this research effort.

entities that were designed and funded by governmental agencies, and then given an objective of breakeven, e. g., U. S. Postal System. The purpose of this sector is to provide the public with collective goods² and services as the public deems appropriate.

The NFP sector bridges the gaps between what the private for-profit sector provides in accordance with its profit maximization objective, and what the public sector provides with the need to protect and provide for the needs of a constituency. The goods and services provided by the NFP sector covers the spectrum from purely private goods to purely collective goods. (Arrow, 1979) Part of the nonprofit sector consists of organizations that are simply instruments of profit maximization for the persons or firms benefiting from the organization's activities, e. g. trade associations. But another part of the sector provides collective kinds of goods similar to those

²Private goods are goods that can be provided and distributed efficiently through the market system. Private goods are characterized by two assumptions. First it assumes that whether or not a person consumes a good depends on whether or not he or she pays the price. Those who pay for the good can consume it, while those who do not pay cannot consume it. Secondly, it assumes that if one person consumes a particular good, someone else cannot consume it too. Examples of private goods are McDonald hamburgers, a bottle of beer, etc. Collective goods also referred to as public goods are goods that cannot be consumed by one person. Such goods can be enjoyed by one person without reducing the enjoyment they give others. (Mansfield, 1975)

furnished by the public sector. Among these would be charities and organizations to promote such causes as environmental preservation or civil liberties, e. g. Green Peace, NAACP, etc. Then in between these two examples is a large population of NFPs like hospitals, boy clubs, YMCA, secular denominational churches and religious groups, private schools, etc.

As stated by Burton A. Weisbrod, the need for the goods and services provided by the NFPs is great. The gap between goods and public goods has to be bridged. The private sector is governed largely by, "can we make money out of it?" (capitalistic way). On the other hand in the public sector, a democratic society imposes constraints on its leaders as to how much and what type of collective goods and services its government can provide. Consequently, there is a gap. The NFP sector exists because of its ability to fill that gap. It meets some of the public demands for collective goods that are unsatisfied by government and it meets the consumer's demand for private goods and services that are unsatisfied by the private business sector. (Weisbrod, 1978) Here lies the basic importance of this NFP sector.

There is not a large selection of literature covering the size of the NFP sector. The best data available shows that as of 1973, there were approximately 650,000 NFP entities or organizations and their aggregate total revenue

was approximately \$531 billion dollars. This represented approximately 18 percent of the revenue of all business firms in the U. S. (Weisbrod, 1977).

The author was not able to find supporting data in the literature concerning the mixture of small versus large NFPs. But if one were to use the private business sector as a guide, some interesting results appear. In the private sector a number of different measures might be used for comparing small business versus large concerns. For example, based on the number of business units, small business is of overwhelming importance. According to Table I, about 95 percent of the firms have fewer than 20 employees, while fewer than one percent have more than 100 employees. This comparison is not completely realistic, however, because of the greater importance of large corporations.

To correct this distortion, employment data can be used to show the distribution of personnel among businesses of various sizes. Even on this basis, small business accounts for a substantial portion of total employment. According to Table I, firms with fewer than 100 employees account for about 40 percent of all paid employment; those with fewer than 500 employees have about 53 percent. Regardless of the exact point at which one draws the line between large and small business, it is apparent that much - perhaps

TABLE I

DISTRIBUTION OF FIRMS AND PAID EMPLOYMENT BY SIZE OF FIRM, 1967*

Size Class (Number of Employees)	Percent of Firms in Operation	Percent of Paid Employment	Cumulative Percent of Paid Employment
All size classes	100.0	100.0	
1 - 19	94.7	21.7	21.7
20 - 99	4.5	18.2	39.9
100 - 499	0.7	13.2	53.1
500 or more	0.1	46.8	99.9**

*Includes data for construction, manufacturing, mineral, retail trade, selected services and wholesale trade industries.

**Total does not equal 100% because of rounding.

Source: U. S. Bureau of the Census, Enterprise Statistics, 1967, Part I - General Report of Industrial Organization, Table 3-1 (Washington: U. S. Government Printing Office, 1972).

close to one half - of American business must be classed as small (Broom, Longenecker, 1975).

If one were to assume that the small NFP represented the same ratio of entities in the private not-for-profit as small business represents in the private business sector, then one could deduce that small NFPs represent at least 325,000 entities and approximately \$260 billion dollars in revenues. However, there are only a few giant NFPs. With the exception of a few very large foundations or national organizations like the YMCA, the United Way, etc., the list of large NFPs is miniscule in comparison to "Fortune 500" "Big Business" types. Extending this further, the number of small NFPs is probably at least 75 to 80 percent of the total NFP population, and they probably generate over \$425 billion dollars of revenue a year.

B. STATEMENT OF THE PROBLEM

The problem is that the private for-profit and public sector are doing a much better job of meeting the changing environment of the economy than the NFP sector. Without some change in direction and behavior, the NFP sector is not likely to survive in the long run, particularly the small NFP.

In the 1970 annual report of the Carnegie Corporation of New York, Alan Pifer, president of the corporation,

stated that "private, for-profit institutions serving the public good" were in serious jeopardy in the United States and might well become insignificant or even disappear altogether within American society. He declared that this would be a national tragedy and would radically alter the structure of American social institutions. Moreover, he said that, even at that time in 1970 the "time for action, whether of a broad or specific nature, is extremely late." (Henle, 1976)

Ten years later, the situation remains virtually unchanged. If there has been a change, it has been for the worst instead of an improvement. Inflation, unions and increased demands for services are taking a hard toll on the NFPs. (Herzlinger, 1979). The key problems revolve around poor management, poor fiscal controls and too much government intervention. (Henle, 1976, and Herzlinger, 1979)

The private sector of the U. S. economy has developed a system of enterprise unparalleled in the world. Managers of these enterprises have been trained in modern business techniques designed to make them more capable of making sound business and investment decisions that will aid their companies in reaching their objectives and goals. These tools include, but are not limited to, such things as financial analysis, systems analysis, human resources analysis and auditing. Many of these techniques and tools

are also being employed by the public sector. The NFP sector, according to the literature, has been the last sector to grasp the benefits of these modern skills and techniques. (Borst, Montana, 1977). The presumption is that basic management concepts can and should be applied to NFP activities just as diligently as to profit-seeking companies. (Newman, Wallender, 1976).

It is not the intent of this paper to explore all of the modern business techniques capable of improving small NFP performance. A task of that magnitude would be beyond the capabilities and resources of this author. Instead, the author has chosen to concentrate attention on auditing, particularly, the operational audit. For if the operational audit is a useful tool in the private and public sectors, then it might offer some benefit to managers of small NFPs.

C. OBJECTIVE

The objective of this thesis is to develop an operational audit model useful to a small NFP, and to test the usefulness of the model by applying it to the industrial activities of the Monterey Bay Academy (MBA). MBA is supported by an industrial complex composed of six different entities, each a small NFP in its own right. Because they are all under the administrative and financial control

of the school's administrator, they will be examined as a group. The entities composing the industrial complex include the dairy farm, produce division, laundry, greenhouse, and surfboard fin manufacturer.

D. METHODOLOGY

The background research for this thesis is based on secondary sources. The basic means of data collection was a literature search of library journals, periodicals and books. A broad based literature search was conducted for information involving several areas of concern. First, a search of economic and management data for a definition and characteristic of a nonprofit organization. Then data was collected to evaluate the benefit of these institutions in the economy, and the type of environment in which they exist. Secondly, accounting literature was reviewed to justify and support the need for an operational audit. Data was sorted to answer the question of how this type of audit evolved, who was best able to conduct the audit, and what benefits might one expect to accrue from this type of procedure. Thirdly, the author went to the Organizational Development (OD) literature. The author went to OD literature in search of information concerning the effective approaches to OD, useful OD techniques, intervention strategies, strategies for change, and appropriate conduct the auditor should preserve throughout the audit.

With data from each of these areas, the author focused the concentration of the effort on the small NFP. Integrating the many sources and references, including nine years of past experience as a Naval Supply Officer, the author formulated an audit model designed to meet the needs and considerations necessary for the small NFP.

In the application of the model, the author personally performed the task of auditor/consultant. In this role as auditor, numerous trips were made back-and-forth to Watsonville, California. In the on-site environment the author conducted discussions, interviews, made on-site observations, conducted seminars, and administered questionnaires in accordance with the outline of the audit model. Based on the data collected and summarized, the author provided the Administrator of the academy with a briefing on audit findings and observations. Then with the Administrator's consent, the written report was distributed and discussed collectively with the managers of the different industrial divisions. Lastly, in support of implementation procedures, the author conducted a six hour seminar (three different two hour sessions) on "Budgeting and Planning."

E. ORGANIZATION OF THESIS

This chapter identifies the general area of the study. The impetus of the study was defined in the statement of

the problem. Two objectives were formulated to help direct the research and provide a focus of the study. Finally, a brief discussion of research methods was offered.

Chapter II discusses in some depth the issues of: What is a nonprofit or not-for-profit organization? From what type of environment did it evolve? What are the most serious problems threatening its existence? Chapter III argues the need for a NFP operational audit. It explains the benefits derived by a manager whose organization is examined by an operational auditor. Chapter IV attempts to bridge the gap between the first few chapters by discussing the various factors that affect the design of an operational audit for a small NFP. Specifically, it examines the assumptions and implications inferred from Chapter II and III. Attention is also given to the special needs and considerations that must be contemplated before intervening into a small NFP, e. g. resistance strategies, management characteristics of administrator, etc.

Chapter V presents the model developed for the small NFP, and outlines the four stages which make up operational audit model "J." The stages are composed of an educational phase, a diagnostic audit phase, an intensive examination phase, and an implementation and assistance phase. Chapter VI presents data based on the application of operational

audit model "J" to a real NFP. Its purpose is to test and hopefully demonstrate the practical usefulness of the model.

Lastly, Chapter VII offers a final note in conclusion. The author discusses the shortcomings or limitations of the model.

II. NONPROFIT ORGANIZATION

The economy of the United States is composed primarily of private business firms - some 13 million in fact - and so historically, it is understandable that economic theory has focused on this private sector. (Weisbrod, 1978).

"For-profit" is the heartbeat of a capitalistic system. When one talks about the private for-profit sector, one could envision organizations built and oriented toward profit maximization and organizations that are evaluated principally on the basis of the efficiency with which it allocates resources.

In recent decades, however, the growth of government has brought about increased efforts by economists to understand what the public sector does and how well it does it. Commanding particular attention have been "collective" kinds of goods, those like national defense, lighthouses at sea and consumer information, that benefit many people simultaneously and non-competitively. The assumption is that only the government can fulfill these kinds of public needs. If given the opportunity, the private business sector is likely to produce inefficiently small quantities of such goods because of the tendency of beneficiaries to be "free riders," that is, to avoid offering to pay for collective goods, waiting instead for

others to pay. The expected result is that the profit sector will not employ resources without a prospect of a favorable return on their investment. Many use this predicament as justification for governmental activity. They allege that only governmental influence can insure that resources are distributed equitably. (Weisbrod, 1977)

But organized economic activity is not limited to firms operating for profit and governmental organizations. There is a third class or sector of market institutions, the private not-for-profit sector. The organizations of this sector depend significantly on voluntary grants of money and of labor time to finance output. They are characterized by their ability to respond to the social needs of selective groups of society. Why do such organizations exist? What social rules do they perform? And what differences or similarities exist between nonprofit organizations and profit oriented organizations are some of the questions that will be explored in this chapter.

A. WHAT IS A NONPROFIT ORGANIZATION?

There is no consensus among economists as to how to describe and predict the behavior of this ill-defined class of organizations that has been termed "nonprofit," "not-for-profit," "altruistic," "philanthropic," "donative," "nonbusiness" and "charitable." (Weisbrod, 1978). A

nonprofit organization may plan for and actually realize an excess of revenues over expenses for any period, but the net income resulting from such excesses of revenues over expenses must be used to implement and/or expand its services. Within this definition, one can then characterize governmental entities, colleges and universities, most hospitals, health and welfare agencies, churches and foundations as nonprofit organizations.

For the purpose of this research effort, nonprofit organizations will be categorized in two ways. Firstly, nonprofit organizations are categorized insofar as public support is concerned. Using public support as a factor, nonprofit entities can be divided into voluntarily and involuntarily supported entities. Private colleges, hospitals, health and welfare agencies and churches are examples of voluntarily supported nonprofit entities. Governmental entities supported by tax assessments make up the involuntarily supported group. Secondly, these organizations can be divided into categories based on the nature of support from their constituencies. For example, some organizations such as hospitals and private colleges are often expected to be self-sustaining, insofar as normal operations are concerned, after receiving an initial capital contribution. In another group are organizations that require full or partial operating support indefinitely. This group includes governmental units supported by periodic

tax assessments, as well as health and welfare agencies, churches and other organizations supported by repetitive voluntary contributions. (Henke, 1977)

For the remainder of this research effort, the research will be primarily concerned with voluntary entities (NFP).¹ NFPs obtain their financial resources almost entirely from revenues from selling goods or rendering services. In order for a school or college to be classified as a NFP, its financial resources must be primarily derived from tuition and other fees for services rendered. Hospitals that are financed by patient charges also meet this test, and all other nonprofit entities that are financed by user charges will also be included as voluntary NFPs. This list includes mutual savings banks and mutual life insurance companies, credit unions and cooperatives that are financed by user charges.

A more precise definition of the NFP can be proposed by understanding what it is which distinguishes them from the private and governmental sectors of the American economy. Three possible differences between NFPs and the private and the government sectors come to mind: one, the tax free status of NFPs; two, the semipublic nature of the

¹Voluntary entities make up the private not-for-profit sector.

goods and services which they provide, and three, their source of funds. Of these three, only the third, the source of funds, really succeeds in distinguishing NFPs from the public and private sectors of the economy. (Copeland and Smith, 1978)

B. EVOLUTION OR ORIGIN OF THE NFP SECTOR

The literature is scarce on the evolutionary development of NFPs. Many feel that because of the unique role and position of the American church and state, these types of organizations have existed as long as the United States. Some have eluded to an ideology struggle between socialism, represented by the Soviet Union, and capitalism, represented by the United States. Each ideological system has sought purity in its guiding principles, despite the fact that they are not mutually exclusive.

The last several decades, private enterprises have played a significant role in the production and distribution of goods and services in the Soviet Union. (Etzioni, 1973). But this activity is considered to be the exception, a residue, a transitory element, or a concession to the old-fashioned. Similarly, in the United States, the existence of large-scale government business, for example, the Atomic Energy Commission and the Postal Service, is viewed as exceptional and either undesirable or to be condoned for

special purposes, such as security or lack of profitability in a vitally needed service. (Etzioni, 1973). As a result, several political analysts have indicated that the capitalist and socialist system, contrary to their avowed intentions, are actually moving toward each other. (Brezinski and Huntington, 1964)

The central theme of the evolvement of the NEFs revolves around societal needs and responsiveness to societies' needs. One group in the American society, the New Left, disapproves of both socialism and capitalism with equal vigor; it wants one no more than it wants the other. The real problem, they feel, is that society is in the iron grip of a group of involuted and bovine bureaucracies, both public and private. These bureaucracies are responsive only to one implacable internal incentive, the perpetuation of their own security and power. Created to get societies' tasks done, they exist now only for themselves, no longer responsive either to their essential task or to society. They operate in a sealed continuum created by and for themselves. Furthermore, the old machinery for conflict resolution and social accommodation - like political participation, legislation, pressure groups and voluntary associations - has, in the view of the new activists, itself become bureaucratized, sluggish and often just plain obsolete. (Levitt, 1973)

With a free enterprise system that provides America with a standard of living far above that in any other country, one would think that there is no place for an NFP sector. However, socially conscious people realize the dependence on profit motivation alone often fails to provide many desirable services for those who must need them. (Henke, 1977). Profit enterprises respond to the needs of the marketplace. These demands reflect not only needs for particular goods and services but also the purchasing power necessary to acquire them. Many persons lack the purchasing power for services they need and desire. Therefore, if it is considered socially desirable for these persons to have such services, a governmental or other nonprofit agency may be established to meet those needs. Thus, tax levies pay for the operation of a public school system and voluntary contributions enable health and welfare agencies to provide socially desirable services for the less fortunate. (Henke, 1977). The idea is not that this third sector will replace the private and public sector of the American economic system, but that it will supplement them by matching and balancing their important roles. Thus, the origin of the NFP sector might stem from its goal of meeting consumer demands for collective goods that are undersatisfied by the government and private business sectors.

NFPs are needed to tend to the needs of major groups in society that clearly need special representation or help. Their primary objective is to supply a socially desirable service without regard for financial gain. The very fact that NFPs are abundant and thriving is testimony to their necessity. They did not materialize accidentally or by immaculate conception. Somebody thinks they are worth the effort. Because of the demand, they are not any less legitimate than business or government. The point is that their mere existence and endurance suggest the presence of a persistent need.

C. ECONOMIC IMPORTANCE OF NFPs

The economic importance and power of voluntary organizations are anything but trivial. In his book, The Voluntary Nonprofit Sector, Burton Weisbrod presents data to reflect the size of the NFP sector. Tax-exempt NFPs file with the Internal Revenue Service (IRS) each year a statement of their receipts, expenses, assets and liabilities (Form 990). Through the use of statistical sampling, he was able to take a sample of NFP returns and use them to project the aggregate revenues of the entire voluntary sector for 1973. From independent sources, he gathered that the universe of voluntary NFPs were approximately some 650,000 in number with an aggregate total revenue of approximately

\$531 billion dollars in 1973. (Table II) According to Weisbrod, this represents approximately 18 percent of the revenue of all business firms in the United States. (Weisbrod, 1977)

One revenue source that is frequently overlooked when considering the NFPs is their nonmoney receipts. Donations of labor services, for example, represent a significant source of support to the NFP sector. A national survey undertaken by the University of Michigan for the Commission on Private Philanthropy and Public Needs disclosed that some six billion hours of labor were volunteered in 1973. This was the equivalent of three million full time workers. Also, the estimated \$29 billion market value of volunteer time actually exceeded the survey's estimate of \$26 billion in private money given in 1973. These estimates generally understate the value of total labor donations because individuals working at wages below their market rate of pay and thus giving what amounts to a partial donation, are not counted. (Weisbrod, 1978)

Describing the size of an organization or a sector of the economy by flows of funds is not the only useful means of assessing its size and importance. One might instead consider its assets. In 1973, NFPs held an estimated \$578 billion in total assets; an amount equal to some 15 percent of all U. S. private wealth. These magnitudes give one

TABLE II

VOLUNTARY NONPROFIT-SECTOR REVENUE SOURCES, UNITED STATES, 1973

Source of Revenue	Type of Organization					(6) All Nonprofit Organizations
	(1) Religion	(2) Education	(3) Health	(4) Cultural	(5) Philanthropic Organizations (Sum of Columns 1-4)	
(1) Sales and receipts	\$2.8 (60%)	60.8 (65%)	31.1 (94%)	0.5 (45%)	95.2 (72%)	121.1 (23%)
(2) Dues and assessments	0.2 (4%)	19.3 (21%)	0.2 (1%)	0.1 (9%)	19.8 (15%)	349.9 (66%)
(3) Contributions, gifts and grants	1.7 (36%)	13.2 (14%)	1.8 (5%)	0.5 (45%)	17.2 (13%)	59.9 (11%)
(4) Total revenue	4.7 (100%)	93.3 (100%)	33.1 (100%)	1.1 (100%)	132.2 (100%)	530.9 (100%)
(5) Percentage of total revenue for all (nonprofit) organizations	0.8%	18%	6%	0.2%	25%	100%
(6) Sample size	25	67	32	34	158	432

Note: Dollar amounts in billions. Figures in parentheses are percentages of total for each (column) subsector.

Source: Weisbrod, B. A., The Voluntary Nonprofit Sector, Massachusetts: D. C. Heath and Company, 1977.

more indication of the size of the NFP sector and they show once again that its size justifies a great deal more attention than this sector has received. (Weisbrod, 1978)

D. ORGANIZATIONAL CHARACTERISTICS OF NONPROFIT ORGANIZATIONS

Within the limits imposed by the legal and economic environments, the operating requirements of an entity largely determine its organizational structure. This is especially observable as one examines the organizational characteristics of NFPs.

Individuals' rights to control the use of their property is a concept underlying the capitalistic system. As a person invests resources in the ownership shares of a business enterprise, the individual acquires a proportional voice in the management of the enterprise. As a result of this basic right, business enterprises are managed by their owners directly, or indirectly through elected boards of directors.

NFPs by definition have no equity interests that can be owned, bought or sold by individuals. Therefore, the rights to their management and control must be established from different relationships. Membership in an NFP may carry a voting privilege regardless of the amount paid or contributed. For example, a citizen has one vote on governmental affairs and a church member may have one vote on

the affairs of his or her church. Control in these instances rests equally with each member regardless of the amount contributed in the form of taxes or church pledges.

NFPs typically have boards elected or appointed in accordance with a charter or other legal documents. In other instances, the constituency, those having a active interest in the entity, may select a board of trustees as the external management group. Either of the methods used to select the external management group is contrary to the arrangement for control being in proportion to ownership as is the case in profit-oriented enterprises.

The board of directors for an NFP is the policy-setting group. All board members can be liable for the group or organization depending on circumstances, such as the law being complex on this matter. The board is legally responsible for upholding the constitution and bylaws. As such, the policies established should be used to meet the purpose or goal of the organization. Also, the board is responsible for deciding who is responsible for what within the organization and how the organization should conduct itself in the community.

E. SIMILARITIES BETWEEN VOLUNTARY NONPROFIT SECTOR AND PROFIT SECTOR

The tendency to emphasize organizational similarities in management of profit and nonprofit sectors is appropriate

because voluntary NFPs like profit organizations are goal seeking, hierarchically structured and require managing. Frequently, the same models of decision-making, same leadership styles and same tools and techniques are used. (Sukel, 1978)

Considering the issues primarily from the perspectives of accountability and resource allocation inevitably brings out the following compelling similarities in all types of organizations, whether they are business or nonbusiness, or whether they are governmental or nongovernmental:

1. Many users having a bona fide interest in non-business organizations are divorced from the day-to-day operations of the organizations. Their position is similar, in this sense, to that of the absentee owners, creditors and other resource providers in many business enterprises.

2. As a consequence, managers are selected to run the organizations. The selection process varies, of course, but the end result is the same. For example, U. S. presidents, mayors, senators and representatives are elected; college presidents and hospital administrators are appointed by boards of trustees; but regardless of the method of selection, they and their chosen subordinates manage the resources of their constituents, investors, creditors and donors.

3. The organizations receive financial resources and the managers are obligated and responsible to use those resources in the most effective, efficient way in attaining the goals and objectives of the organization.

4. The bona fide interests in the organization have a right to receive periodic reports which will aid them in making rational decisions on issues such as how they will allocate their scarce resources and determining whether those resources they have committed are being well used to reach the objectives and goals of the organizations.

(Management Accounting Practices Committee, 1979)

These four major characteristics prevail regardless of the type of organization involved and are essential in deciding whether or not the same basic concepts should apply to all kinds of organizations. In other words, they are critical in determining the basic, general needs of users to evaluate past resource allocations and to make future allocation decisions.

F. FACTORS AFFECTING THE STABILITY OF THE NFP SECTOR

While Big Business is healthy and Big Government continues to grow, the third sector, unfortunately is in trouble. Many colleges, hospitals, churches, social agencies, performance groups and museums are increasingly

feeling the pinch of rising costs and stable or declining revenues. Consider the following: (Kotler, 1979)

1. More than 170 private colleges have closed their doors since 1965, unable to get either enough students or funds or both. Tuition at Stanford and Yale is now over \$6,000; if college costs continue to climb at the current rate, the parents of a child born today will have to put aside \$82,830 to buy that child a bachelor's degree at one of the better private colleges.
2. Hospital costs continue to soar, leading to daily room rates of \$300 or more in some large hospitals; many hospitals are experiencing underutilization, particularly in the maternity and pediatrics sections. Some experts have predicted the closing of 1,400 - 1,500 hospitals in the next ten years.
3. The Catholic Church drew as many as 55 percent of all adult Catholics under 30 years of age to church in the typical week in 1966. By 1975, the figure had fallen to 39 percent and further declines in weekly attendance were expected.
4. Many performance groups cannot attract large enough audiences. Even those which have seasonal sellouts, such as the Lyric Opera Company of Chicago, face huge operating deficits at the end of the year.
5. Many third sector organizations that flourished in earlier years - the YMCA, Salvation Army, Girl Scouts and Women's Christian Temperance Union - presently are reexamining their mission in an effort to reverse membership declines.

Like every other sector of the economy, the NFP sector is perplexed with situations and conflicts that threaten the growth and prosperity of this sector. Some of the problems effecting NFPs are internally controllable, while others are affected by the external environment. In either case, the problems directly affect the NFP sector and will cause the managers of these organizations to modify their present mode of operations, if they are to continue to survive.

If the NFP sector is to be a continual force in the economy in the long run, then these problems must be overcome. For if they continue on their present course, these problems will lead to the downfall of the NFP sector. (Henle, 1976). Or the public sector, if it chooses, will have to find a way to act as a financial prop for the NFP sector.

Current literature establishes the fact that internal and largely controllable problems of the NFP sector include poor fiscal management, the lack of a systematic and uniform accounting and reporting procedures, and poor information systems. (Herzlinger, 1979). The external factors affecting the NFP sector revolve around past abuses of NFPs. Many feel that the tax advantages, price discriminatory mechanisms, lack of full disclosure of financial data and the lack of adequate government control has caused an increase in complaints and actions from the general public, especially from the for-profit sector. For the remainder of this section, the research will explore some of these areas of conflict such as poor fiscal management, poor accounting procedures and poor information systems.

1. Poor Fiscal Management

The financial vulnerability of this nations NFPs is something heard about every day. The news media is full

of correspondence about the difficulties of both governmental and private NFPs. Everyone was shocked to hear of the potential bankruptcy of New York City. One also hears on a periodic basis that the nation's Social Security System is in poor financial condition, and that the very life of the private colleges and universities is being threatened.

Some managers of NFPs feel that these financial difficulties have been brought about by inflation, increasing demands for nonprofit organization services, and the rise of unionism. But are these the real problems? Dr. Regina Herzlinger disagrees. "Certainly inflation, unions and increased demands for services have affected the costs of nonprofit organizations," says Dr. Herzlinger, "but private-sector (for profit) organizations also have to contend with these factors and seem to be more successful at it." (Herzlinger, 1979, p. 60)

Dr. Herzlinger feels that the difference lies in the neglect of proper procedures for fiscal management, a neglect that is apparent in the behavior of the nonprofit organization managers, and in the absence of systems of sound fiscal management. The indifference of the top managers of most NFPs to matters of fiscal management is pervasive; many of them are professionals, untrained and unskilled in this area, preferring to delegate it entirely

to their technical subordinates, "the accountants," or to dabble in it only to the extent of fund raising, stating, "If we have a problem, I'll go out and raise funds to meet it."

On a technical level, organized, articulated and integrated systems for planning, resource allocation, budgeting and evaluation are usually absent. That is not to say that the entire NFP sector suffers from this problem; indeed, some of the most innovative techniques in fiscal management have sprung out of the sector. Examples are program budgeting, benefit-cost analysis, social accounting, and zero-base budgeting. Rather, the point is that while isolate NFPs may have done well in some particular aspect of fiscal management, such as zero-base budgeting, few organizations have complete, integrated fiscal management procedures of the kind found in the private sector or the managerial climate that fosters such procedures. This absence is at the heart of the financial pressures of most NFPs. (Herzlinger, 1979)

2. Poor Accounting Procedures

"Anything goes!" This is how Marvin Cross categorizes the accounting procedures of NFPs within the last decade. NFPs have become so pervasive and prolific in American society that an understanding of their

financial reports is vital. Vital, not only to their managers and boards of directors, but also to private citizens who contribute time and money to them or rely on them for needed services. It is a fact of American life that most of the public is involved in either the functioning or use of services of NFPs.

Naturally, there is concern regarding the way NFPs handle their assets, and as with all enterprises, the major sources of such information are financial reports. Again as with all enterprises, the purpose of these reports is to communicate the financial position of the organization to the reader. Yet, current methods of NFP reporting are diverse and complex. As discussed before, these offer an uninviting challenge to the uninitiated lay person and insufficient clarity to the business person and the accountant.

To demonstrate how far behind NFP accounting efforts are, as opposed to the private sector, it was as late as 1977 when the Financial Accounting Standards Board (FASB) asked Professor Robert N. Anthony of the Harvard Graduate School of Business to look into the financial statement objectives and basic accounting concepts of nonprofit organizations. Generally accepted accounting principles (GAAP) for profit-oriented businesses have been around since 1930. But because of the impact of the profit motive on the private oriented business, GAAPs were not readily appropriate for the NFP sector. Presently, however

there is growing concern about accounting and reporting for governments and other nonprofit entities and the FASB is responding to it.

Professor Anthony, assisted by the "knowledgeable people with varied viewpoints who are closely associated with NFP entity accounting," covered both public and private nonprofit organizations. His initial research was to help the FASB decide whether these organizations needed a separate conceptual framework, and if so to provide a basis for discussing such questions as who uses NFP financial statements, and how, and what the basic reporting concepts should consist of.

a. Poor Accounting Educational System

In view of the problems and inconsistencies confronting the NFP sector in establishing a sound accounting system, one would expect that business schools would be directing emphasis and attention to this sector. But in effect, accounting education often ignores the NFP area, or at best, merely pay it lip service. (Marino, 1977)

Marino conducted a random sample survey of one hundred colleges or universities with undergraduate degree programs in accounting. The results of his survey indicated that 78 percent of the institutions surveyed include the topic of accounting for not-for-profit organizations in their accounting curriculum. But this is somewhat misleading,

for closer inspection reveals that only 45 percent of the institutions surveyed offer courses in this area. Of the remainder, 22 percent do not address the topic at all. The final 33 percent include the topic in some other course. but the majority of these respondents state that they devote a maximum of two weeks to the subject. In summary, approximately one-half of the institutions surveyed either exclude the topic from the curriculum or do not spend more than two weeks addressing it. This is especially alarming when one realizes that the recent trend has been to deemphasize rather than emphasize this topic.

The problems which currently plague the accounting and financial reporting practices of the nonprofit sector cannot be completely solved at the professional level. Rather, the problem must be addressed more aggressively by the accounting educational system than is currently the case. For no matter how uniform its accounting and reporting practices might become, nonprofit accounting will remain a distinctive and complex subject, and will continue to demand more attention in accounting education than it is currently receiving.

b. No Central Governing Authority

Congress is also aware of the difficulties surrounding the NFP sector accounting methods. About six years ago, Congress established the Commission on Private

Philanthropy and Public Needs entitled the Filer Commission to study public philanthropy in the United States. One of the Commission's most significant findings was that accounting methods employed by NFPs were not codified, were outdated, and could result in abuses of financial disclosure.

In response to these findings, the American Institute of Certified Public Accountants (AICPA) established a group to study the problem and ultimately to codify new rules of accounting and disclosure. Some may wonder why accountants had not written such rules earlier. In part, it was because most attention had been focused on commercial enterprise accounting. Also, the nonprofit area was not recognized as large enough to warrant attention, nor was it perceived that significant abuses could occur or were occurring. However, the AICPA did make a start with a Hospital Audit Guide (1972) followed by Audit Guides for Colleges and Universities (1973) and Voluntary Health and Welfare Organizations (1974).

The reality of the situation is that the NPF institutions are coming under increased public scrutiny. The public has expressed concern about the lack of public accountability, and the occasional newspaper headline about an organization that has abused its public confidence merely highlights this concern.

The reaction to this public concern has surfaced in the form of both state and federal legislative proposals. Proposed laws ranged from those aimed primarily at providing disclosure to those that would actively regulate nonprofit institutions. The common element in all this legislation has been the requirement that financial statements be prepared in accordance with uniform accounting principles. These principles would not necessarily be in accordance with GAAP, and typically the administering agency would be allowed to develop the accounting principles based on the institutions being regulated.

Legislation providing that a government agency develop accounting rules obviously is disturbing to the accounting profession. Thus, the question arises: Why have accountants not been more successful in getting GAAP written into this nonprofit legislation? The answer appears to have two parts. First, many legislators and regulators seem not to be aware of the concept of GAAP, and, when they are, they are concerned that financial reporting under GAAP is too complicated for the public. Second, except for the three audit guides, GAAP has not been formally codified for the nonprofit sector. Furthermore, the guides have been in existence for a relatively short time, and many organizations are still not following them. (Gross, 1977)

With separate committees dealing with the problems of individual types of nonprofit organizations, there

were inconsistencies among the guides on the proper handling of similar issues and transactions. This occurred because the individual committees had worked closely with industry representatives and had based their work on the industry accounting manuals.

However, the absence of an authoritative document applicable to types of organizations not covered by existing guides created awkward situations. Certified Public Accountants could urge clients not covered by a guide to follow, say, the principles in the voluntary health and welfare guide, but clients wanting to follow a contrary principle could often find justification for doing so in one of the other guides.

The absence of accounting rules must be a concern to accountants because if the accountant's organizations do not quickly develop meaningful accounting principles and reporting practices for the NFP sector, the Congress will do it for them. Legislators and regulators are not timid about stepping into the accounting rulemaking arena. (Gross, 1977)

3. Poor Information Systems

Another problem that reflects directly on managers of nonprofit organizations relates to their handling of information and control systems. Nonprofit institutions have as much need for efficient information and control

control systems as for-profit organizations do; after all, top management in the "nonprofits" are similarly burdened with acute budgeting problems and policy issues whose resolution depends on the availability and sensible exploitation of accurate, current data. (Herzlinger, 1977)

Yet Herzlinger characterizes the nonprofit organization as one often burdened with slovenly, unbusinesslike accounting practices, and seat-of-the-pants style managers whose combination result in neglect and poor handling of the in-house information systems. In fact, Herzlinger describes the state of control and information systems in most nonprofit organizations as dismal. Despite billions of dollars spent to provide relevant, accurate, and timely data, few nonprofit organizations possess systems whose quality equals those found in large, profit-oriented corporations. Nonprofit organizations do not lack data; if anything, they enjoy an overabundance of numbers and statistics. Rather, they lack systematically provided information to help management do its job. Without good information, it is obviously difficult for managers to make reasoned and informed decisions, evaluate performance, motivate their employees and protect the institution against fraud.

4. Inability to Comprehend Environment

Some authorities feel that the most influential movement that threatens the very existence of NFPs are the

complaints from the for-profit sector concerning abuses of tax advantages, abuses of postage breaks given to NFPs, abuses of property taxes, outright mismanagement, and the establishment of relationships with individuals and businesses that are less than arms length relationships. Most of these issues revolve around ethical considerations, but as with many factors of society, the few "bad apples" often create such a poor public image that it causes the public and government to overreact.

A special report titled, "For Many, There are Big Profits in Nonprofits," U. S. News and World Report (6 Nov 78) presented a confusing and frightening picture of the NFP sector. According to this article, under the label of "nonprofit" are organizations that are prone to:

- pay their executives fat salaries and allow them generous fringe benefits.
- award contracts to their trustees and board members.
- serve as fronts for commercial enterprises with which they have "sweetheart" deals.
- enjoy special mailing privileges and property tax breaks that give them a competitive edge against tax-paying businesses.
- engage in wasteful and sometimes fraudulent and misleading fund raising with little accountability to the public.

a. Tax Advantages for NFPs

Says former Internal Revenue Commissioner Sheldon Cohen, "Nonprofits are a whole can of worms that

Congress has yet to look at in a broad way. I've been blowing a trumpet for years to get lawmakers to spell out clearly what should be tax-exempt and what should not." (U. S. News and World Report, 6 Nov 78)

Experts in the tax-exempt field say there are many organizations around the country that are straining the definition of "nonprofit" to the limits. That is because the law permits many of these groups to operate commercial enterprises, often with little risk of losing tax-exempt status. Colleges, churches and charities can collect rent on offices and apartment buildings without paying any taxes on that revenue as long as they own those properties outright. Since 1969, nonprofit organizations have been obliged to pay taxes on income from "unrelated businesses," such as restaurants or factories. However, there are exceptions to the rule and opinions among local IRS examiners vary as to what constitutes an unrelated business. There are many colleges and universities around the country that operate motels and restaurants and maintain stores that sell refrigerators, motorcycles and other items not related to education. Not only do these establishments take business away from local merchants, but the revenues are often tax-exempt, depending on the rulings of IRS examiners.

Explains Joseph Tedesco, Director of the Exempt Organization Division of the IRS: "It's up to us to determine

whether a school can sell a sweat shirt and not a Honda, and we must take responsibility for the decision and answer the complaints from competing stores." (U. S. News and World Report, 6 Nov 78)

More than 140,000 nonprofit fraternal organizations also operate insurance arms, health programs and other services, which are tax-free as long as sales are exclusively to the group members. These services often are in competition with tax-paying commercial firms. The Knights of Columbus life insurance program, for example, has about four billion dollars worth of insurance business. Lutheran Brotherhood has about 7.7 billion dollars worth.

b. Price Discrimination

In addition to the tax advantage the NFP sector has been given exemption from the Robinson-Patman Act. The Robinson-Patman Price Discrimination Act of 1936 makes it illegal for an organization to discriminate in price between different purchases of like products where "the effect of such discrimination may be substantially to lessen competition." This act was passed to prohibit methods whereby "large buyers gained discriminatory preferences over smaller ones by virtue of their greater purchasing power ." (15 U. S. C. 13a). However, the Nonprofit Institutions Act of 1938 exempts from the provisions of the Robinson-Patman Act "purchases of their supplies for their own use by schools,

colleges, universities, public libraries, churches, hospitals and charitable institutions not operated for profit." (15 U. S. C. 13c)

The case of Abbot Laboratories et al. v. Portland Retail Druggists Association, Inc., decided by the Supreme Court on 24 March 1976, expands the exemptions of nonprofit organizations from the price discrimination provisions of the Robinson-Patman Act. It threatens to place profit seeking organizations in severe competitive disadvantages against nonprofit organizations in markets where they compete for nonindigent consumer purchases. The court decided that for several categories of operations both profit and nonprofit making divisions of nonprofit organizations may enjoy discriminatory purchasing advantages over profit seeking organizations. (Nielsen, 1977)

c. Postal Rate Differences

Many for-profit companies, feeling the pinch from zooming postal rates and higher taxes, are taking aim at the special privileges given to nonprofits. Congress provides the Postal Service with 600 million dollars of taxpayers' money annually to make up for nonprofit organizations' lower postal rates. Leaders of nonprofit groups argue that this subsidy is a small price to pay for the services they give to the public, services that government might otherwise have to provide. (U. S. New and World Report, 6 Nov 78)

Critics, however, see it another way. Says Charles S. Mill, the President of American Business Press: "It is my observation that many nonprofit mailers do not involve themselves solely in charitable or educational work, but instead are engaged diligently in proprietary activities such as masscirculation publishing, soliciting advertising of all kinds and selling services such as insurance policies to their members. In many cases, these proprietary activities consist of unfair competition with tax-paying competitors." (U. S. News and World Report, 6 Nov 78)

Also studying NFP groups is the U. S. Postal Service which has grown sensitive to increasing complaints about the cheaper rates given to these organizations. The service is beginning a new system to spot changes in the IRS's list of tax-exempt organizations so that special mailing privileges can be revoked as quickly as possible.

d. Property Taxes

People are concerned, too, about the exemptions on property taxes given to NFP groups. Critics say that this type of exemption has put more of a burden on homeowners and businesses. An example of how such exemptions can get out of hand is found in the tiny community of Hardenburg, N. Y., situated in the Catskills. There, 213 homeowners, facing soaring tax bills as a result of exemptions given to big landowners, had their homes declared

churches to get them off the tax rolls. The residents became ministers of the Universal Life Church, a California-based organization that mails out divinity degrees for a \$20 offering.

e. Current Efforts to Halt Abuse

In 1969, Congress took what was thought to be a strong step to stop conflicts of interest in foundations. The 1969 legislation¹ ordered stiff fines for foundation officials engaging in "self-dealing," that is, benefiting personally from business transactions with their foundations. The IRS since then has audited about 25,000 foundations. The problem with this legislation has been that it did not require public disclosure of financial data. As a result, only 500 of the 26,000 private foundations publish annual reports.

This law also did not prohibit conflict-of-interest situations in other kinds of nonprofit groups. For example, the Cousteau Society, a New York conservation group founded by Jacques Cousteau, the underwater explorer, has an officer and a board member who both belong to the law firm that handles the society's legal work. In the past, the society has also paid a firm owned by a board member to handle fund solicitations and has purchased services from for-profit

¹Section 511 and 512 of the Internal Revenue Code

operations controlled by Cousteau. These practices, while frowned on by the Better Business Bureau and other charity watchdogs, are legal under current law. The society last year raised about 3.2 million dollars.

There are signs of new campaigns and allegiances to stamp out such abuses and clip the wings of some NFPs. For example, Representative Charles Wilson (D-Calif) has introduced a bill that would require NFP organizations soliciting charitable contributions from the public to disclose information about how that money is to be spent, and thereby protect the American public and responsible NFPs from dishonest moneymaking schemes and grossly inefficient operations.

The IRS is stepping up its review of NFPs, particularly in the area of unrelated business income. Congress in 1974 established a separate IRS office to monitor tax-exempt organizations. Funds and manpower for that operation are increasing. A major examination of the 1,500 largest tax-exempt organizations is just being completed, and non-profits are already feeling the heat. Says Rod Hader of the American Chemical Society: "The IRS is looking for anything it can attack in large nonprofit organizations in order to collect more revenue."

Former IRS Commissioner Cohen argues that what is really needed is broad review by Congress of nonprofit institutions. "So far, actions taken have followed a

Band-Aid Approach," he explains. "Congress simply enacts statutes as a response to individual scandals." (U. S. News and World Report, 6 Nov 78). Meanwhile, there is no let up in the flood of new organizations seeking tax-exempt status. That number has increased from 33,556 to 50,649 last year, a growth that alarms people who are skeptical about the benefits given to these groups. Says Robert Kerwick, the tax assessor of Hardenburg, N. Y.: "We just can't go on giving nonprofit status to every fly-by-night organization that comes down the pike. That has to stop, especially the way economic pressures are building on people." (U. S. News and World Report, 6 Nov 78)

f. Held from Federal Government

What about the Executive Branch of government? Many feel that the federal government has tried earnestly to help, but because of the bureaucratic beast that it is, the federal government's efforts to help at times have been counterproductive. (Henle, 1976). The main problem with the federal government has come from its genuine and honest decision to support the private institutions of this country and their public service, to keep them in existence and to strengthen their ability to render public service. It recognized that private institutions, despite increasing philanthropic support, were moving into serious financial difficulty and that the only agency strong enough to provide the additional funds needed was the federal

government. The federal government, therefore, recognized as a matter of public policy and public interest, that to support such institutions was within the purview of government and was a proper and, indeed praiseworthy, use of the taxpayers' money.

These private NFP institutions welcomed the federal government's efforts initially because it was felt that some regulatory guidance was needed, for example, diploma mills were eliminated. Nonetheless, the sheer mass of the regulations now pouring out of the federal agencies has become an intolerable burden and often places conflicting obligations on the recipient institutions. A recent study demonstrates that the increase in federal government requirements, particularly for diverse and contradictory reporting, has cost higher education an enormous quantity of added expense amounting in some large institutions to over hundreds of thousands of dollars a year. In other words, the federal governments' aid which was to enable these NFPs to carry out their missions, whether it was education, research, culture or whatever, is draining the financial stability of the institutions. (Henle, 1976)

In an unprecedented concentration on a single issue, President Derek Curtis Bok of Harvard devoted his entire 1974 report as president to the problem of government

regulation, control and outright interference in the activities of a great, free university. The presidents of four of the major universities in the Washington D. C. area, American University, Catholic University, George Washington University and Georgetown University, decided that "the situation was so serious and was receiving so little attention that a dramatic insistence on the critical nature of the situation was necessary." With this purpose, the four presidents issued on 13 April 1976, a "1976 Declaration of Independence," in which they attempted to bring dramatically to the attention of all citizens the dire position of private higher education in this country." (Henle, 1976)

The higher cost to these institutions because of the requirements imposed on them is not the only problem that these institutions face because of the federal bureaucracy. Presently, the federal government has set its objectives of financially assisting private institutions of the NFP sector on a collision course with its broader social objectives, and as a result, these objectives become internally contradictory and difficult to administer. A case in point is the one instanced by the President of Yale, Kingman Brewster, Jr. Money was given to the Yale University Medical Center to carry out cancer research. Obviously, this money was not given for the private benefit

of Yale or anybody there, but for the welfare of the general public and the enhancement of their life expectancy. However, this money can be summarily and immediately stopped, and the research as well, by a federal investigator in the athletic department who may determine that the university is not complying with federal regulations because the showers provided for female athletes are inferior to those provided for male athletes.

In the end analysis, every facet of society is aware of the difficulties and problems of the NFP sector. And like opinionated situations, every faction has its own idea of what is needed to solve the problems of a declining third sector. The next section presents some of the exigencies that would result in a stronger NFP sector.

G. REQUIREMENTS FOR THE SURVIVAL OF THE NFP SECTOR

NFPs are at a cross road. They have come to a point where many question their ability to survive. And the most common reason cited for their failure is poor management. The question becomes, "Can nonprofit organizations be well managed?" Robert Anthony gives a qualified, "Yes." In exploring this question, he lists six hurdles that must be surpassed by managers and top executives of NFPs. They are: 1. absence of a profit measure; 2. the absence of competition, 3. politics, 4. weak governing boards, 5. tradition, and 6. low management salaries.

Anthony felt that the difficulty of defining objectives, of deciding on the resources required to reach objectives, and of measuring the efficiency and effectiveness with which the organizations perform to meet objectives comprise the most serious management problem in a NFP organization. But managers in NFPs can be effective if they would not strive to improve their control systems.

Another factor necessary for success in an NFP environment is competition. The driving force of the economy is competition. In most NFPs, the force of competition is muted. Business companies compete for customers; they do everything they can to woo prospective customers. In many NFPs, the new client is not an opportunity, but a problem. It is not a source of revenue but a source of headaches. In order for an NFP to be well managed, its leaders must develop ways of interjecting competition into the system. This is possible whenever units of an organization perform a similar service or whenever a unit performs a service that is also performed in the private sector.

To further justify his qualified "yes," Anthony points out that managers can be more effective if they are sensitive to the political environment, and at the same time able to lessen the political influence on their organization. This political awareness also impacts on their selection procedures for board members. The time has come

to select board members that are not only competent in their own field, but also elect only board members that possess the skills that are necessary to perform the job at hand. This means of course that boards must move away from the "rubber stamp" syndrome prevalent in many NFPs. Board members must become intimately involved in setting policies and providing direction for top managers.

The tradition that the head of an organization should be a technical specialist disappeared from business companies early in the twentieth century. It persists in NFPs and results in the selection of top individuals who simply are not qualified to manage. Indeed, many of these technical experts do not even enjoy management. They would be happier working at their specialty. (Anthony, 1971)

A second influence of tradition is that NFPs have been slow to adopt modern management techniques. NFPs do differ from profit-oriented companies, but they also have much in common. They both have objectives; they both make decisions about the use of resources to accomplish these objectives; and, in both cases, an important management function is to see to it that the organization uses these resources efficiently and effectively. Business companies have developed a number of valuable tools for aiding management in this process: budgets, responsibility centers, cost analyses, standard costs, analyses of variances,

management by objectives, linear programming, probability analysis; the list could be extended indefinitely. Most of these can be used, or adapted for use, in NFPs, but NFPs are slow to do so.

The final point Anthony makes concerns pay. He feels that in order for the NFP sector to attract better managers, they need to make the profession of management in NFPs more attractive to young people who are choosing a career. The principal way of doing this is to increase management salaries. Especially the top management salaries for these are the positions which young aggressive managers are aspiring.

Peter Drucker, however, takes a slightly different approach. He feels that NFPs need more than "great men." They need managers who can discipline themselves to be systematic in their approach to managing. This type of manager has the ability to detach oneself from the day-to-day problems.

1. They are able to ask themselves and their organization questions like, "What is our business and what should it be?" These managers have the ability to bring out into the open alternative definitions and to think them through carefully, perhaps even to work out the balance of different and sometimes conflicting definitions. In other words, they are able to think through their own specific function, purpose and mission.

2. These managers are able to derive clear objectives and goals from their definition of function and mission. They discover early that what they need is not "better people," but people who do the management job systematically and who focus themselves and their institutions purposefully on performance and results.

3. They then have to think through priorities of concentration which enable them to select targets; to set standards of accomplishment and performance; to set deadlines; to go to work on results, and to make someone accountable for results.

4. Next, they need to define measurements of performance and to use these measurements to "feed back" on their efforts.

5. Finally, they need an organized audit of objectives and results, so as to identify those objectives that no longer serve a useful purpose or have proven unattainable. They need to identify unsatisfactory performance, and activities which are obsolete, nonproductive, or both. And, they need a mechanism for sloughing off such activities rather than wasting their money and their energies where the results are not.

So as one can see, these two prominent business leaders both seem to agree that in order for NEFPs to continue to function successfully, they will have to adopt innovative

tools and techniques now being used by organizations in the profit sector. As a result of this concept, many hospitals, welfare agencies, little theatre groups and even universities are seeking help from business sources in managing their affairs. The assumption is that basic management concepts can and should be applied to NFP activities just as diligently as to profit seeking companies.

Many proponents of this theme are encouraging managers of NFPs to develop expertise or hire individuals with knowledge of goal-oriented budgetary processes, and/or to develop skills and expertise in applying management-by-objectives techniques. (McConkey, 1975). Others feel that the salvation of the manager may be the use of marketing techniques and strategies, or consumer affairs feedback systems. (Kotler, 1979). While still others say managers of NFPs should adopt a broader policy of using consulting services, and attempt to join together in a system that would allow them to share services. (Mittenthal and Mahoney, 1977)

Each of these suggestions has the capability of extending or increasing the managers scope of their domain. Each idea has a central theme, the acquisition of pertinent information to allow the managers to assist their organization. Therefore, theoretically one can make better decisions.

The managers of NFPs like a profit-oriented manager need to understand where their organization is now, before they can guide it to where it should be in the future. One useful method of assessing an organizations' health is an expanded audit or internal auditing system. The purpose of an expanded audit is to provide top management with a snap-shot view of the total organization and how each part functions in respect to the other parts. (Dilley, 1975)

This technique has been used extensively in the for-profit sector, but it is fairly new of the NFP sector. The following chapter will provide the purpose and possible usefulness of expanded audits to NFP activities.

III. A CASE FOR OPERATIONAL AUDITS

A. PERSPECTIVE

The establishment and implementation of internal reporting systems, conducting attitude surveys and monitoring independent annual financial audits cannot adequately assess the general condition of a modern, complex organization. A company president or chief executive officer today probably does not receive many letters like the one below. But in ten years, they may be commonplace. (Napier, 1975)

Dear Sir:

Does your company pay for an annual physical for the company president? Why? Probably to get an estimate of his general condition. Does he conduct this examination himself? Ridiculous. Why not: He would not be very objective, even if he were qualified, right?

Does your company get an annual "physical?" Why not? Wouldn't you or your board like an objective evaluation of its condition? Do you think you are in the best position to do it? Is anyone within the company?

We are a group of professionals who attempt to study a wide range of organizations and how they are managed.

We'd like to perform a general management evaluation for your company, from an outside, objective viewpoint. It would be of considerable value to you, performed in a minimum of time at the company with the least possible interference with your normal operations and the results presented to you personally or to others you may wish to designate.

We would be happy to provide more details or to answer any questions. Just call or write us at the address below.

Sincerely yours,

This letter summarizes the purpose and general intent of an expanded scope/comprehensive audit. For several years, a new type of auditing has slowly been evolving. It is being referred to as the expanded scope or comprehensive audit. It has been described in a number of ways: operational audit, social audit, audit of economy and efficiency, program results audit, performance audit, legislative auditing and legislative program evaluation. Although this new type of audit has many different manifestations, it does have a common characteristic, the concern is primarily with types of reporting other than conventional financial statements. (Diley, 1975)

For the purpose of this research effort, an operational audit will be defined as a subset of an expanded scope/comprehensive audit. The easiest way to describe the nature

of an operational audit is to first define the broader scoped comprehensive audit, and secondly, describe its component parts or elements. An appropriate definition of such an audit might be as follows:

A systematic examination of records and other sources of information, conducted by a competent and independent authority for the purpose of obtaining evidence to support an evaluation and judgement concerning, (1) the adequacy and reliability of the information and control systems, (2) the effectiveness of programs to accomplish their intended objectives, (3) the faithfulness of administrators and operating personnel in adhering to prescribed rules and policies and complying with legislative and executive intent, and/or (4) the fairness of financial statements and performance reports issued by managers with the intent of disclosing present conditions and/or the results of past operations and programs of an organization. (Knighton, 1976)

This definition sets forth a broad range of audit activity by spelling out the many objectives for which audits are conducted. An audit may be undertaken for any one or a combination of these purposes. A comprehensive audit would include them all.

If this comprehensive definition of auditing is broken down into its component parts, each corresponding to one of the four basic areas of managerial responsibility and accountability, the following four types of audits can be said to make up a comprehensive audit:

1. Financial Audit: A financial audit is basically an examination of financial records and controls, for the purpose of determining that funds are legally and honestly spent, that receipts are properly recorded and controlled and that financial reports and statements are complete and reliable. This is by far the most pervasive type of auditing conducted in governments today.

2. Compliance Audit. A compliance audit is an examination to determine whether or not managers have adhered faithfully to legislative, legal, and administrative requirements and policies. Some compliance auditing can be done as an extension of financial auditing, while other aspects of compliance auditing must evaluate compliance with non-financial requirements, policies and legislative intent.

3. Operational Audit. An operational audit includes an examination to obtain evidence with which to evaluate the efficiency of operations and the effectiveness of operating policies, procedures, practices and controls to promote efficiency in operations. It includes an evaluation of the utilization and control of non-financial resources, such as property, equipment, personnel, supplies, etc.

4. Program Audit. A program audit is an examination to obtain information with which to judge the effectiveness and accomplishments of public progress. It focuses heavily on the management control system and the reliability of information contained in performance reports that purport to disclose the results of operations in terms of program outputs or accomplishments. (Knighton, 1976)

The purpose of this chapter is to explore the nature of an operational audit, to examine its potential benefits as well as its limitations, and finally, to adjudicate the applicability of this techniques to the NFP sector.

The concept, operations audit, appears in the literature as operational auditing, management auditing, performance auditing, systems auditing, efficiency auditing and a few others. As might be expected, the above definition is only one of a variety of definitions offered to explain the purposes and objectives of operations auditing. These definitions have ranged from the extreme of "management

auditing is characterized more by a state of mind than by distinctive methods," (Cadmus, 1964) to the other extreme of "management auditing is an audit which results in a statement of opinion by a CPA with regard to the performance of the management function." (Churchill and Cyert, 1966). The authors of one article even attempted to develop the underlying postulates of the theory of management auditing as it might be performed when merely an extension of the annual financial audit. (Langenderfer and Robertson, 1969). Perhaps the following "middle-of-the-road" definition is more appropriate, and more useful in explaining the scope of this particular article.

Operations auditing is:

A systematic review and evaluation of an organization, or subunit thereof, made with the purpose of determining whether the organization is operating efficiently. It is in effect, an organized search for efficiency-related problems within the organization. (Norgaard, 1969)

There are two reasons for not accepting the definition that relates to the CPA giving an opinion on the performance of management. First, there are no objective and generally accepted measurement standards for determining the efficiency of management. Second, CPAs would be exposed to an unprecedented degree of liability to third parties if they were to attempt to give opinions on various human qualities. The search for efficiency-related problems does not involve these two distracting attributes.

Other published definitions of operations auditing that might help to explain the concept as it is used here include the following:

Operations auditing is a technique for regularly and systematically appraising unit or function effectiveness against corporate and industry standards by utilizing personnel who are not specialists in the area of study with the objectives of assuring a given management that its aims are being carried out and/or identifying conditions capable of being improved. (Lindberg and Cohn, 1972)

Operations auditing is a review and appraisal of the efficiency and effectiveness of operations and operating procedures. It carries with it the responsibility to discover and inform top management of operating problems, but its chief purpose is assisting management to solve problems by recommending realistic courses of action. (Pyhrr, 1969)

Dale Flesher takes exception to this last definition. He feels that it is not totally acceptable because of the phrase stating that the auditor should include specific recommendations and courses of action. Although many authors have defined operations auditing as both a problem-finding and problem-solving tool, the most recent works on the topic have emphasized the fact that the tool is useful only to determine what efficiency-related problems exist. There is nothing new about trying to solve problems; it is the techniques of trying to find problems that is of more recent vintage. The operations auditor does not offer suggestions as to how problems might be solved. (Lindberg and Cohn, 1972). The job of operations auditing is finished when the problems have been located, identified

and defined. The development of solutions is the job of management, management consultants or the management services department of a CPA firm. The solving of identified problems is not a new concept; the systematic search for problems and opportunities for increased efficiency is new. (Flesher, 1977)

The operational auditing concept is not new; it has been around since at least 1875. In that year, a German armament maker's audit manual stated:

"The auditors are to determine whether laws, contracts, policies and procedures had been properly observed and whether all business transactions were conducted in accordance with established policies and with success. In this connection, the auditors are to make suggestions for the improvement of existing facilities and procedures, criticisms of contracts with suggestions for improvements, etc." (Gravelle, 1974)

It has only been since World War II that operational auditing has gained stature as a valuable tool of management. As a matter-of-fact, it was a public not-for-profit organization that is given credit for the formal introduction of operational auditing in the late 1960s. That organization was the General Accounting Office (GAO). Not until 1972, when the GAO published its "Standards for Audit of Governmental Organizations, Programs, Activities and functions"¹ did the accounting profession begin to develop one of its most productive and beneficial tools.

¹ sometimes called the "Yellow Book." It discussed the so called "Three E's" of economy, efficiency and effectiveness.

The GAO's "Yellow Book" described auditing for economy, efficiency and effectiveness as follows:

A review of efficiency and economy shall include inquiry into whether, in carrying out its responsibilities, the audited entity is giving due consideration to conservation of its resources and minimum expenditures of effort. Examples of uneconomical practices or inefficiencies the auditor should be alert to include:

1. Procedures, whether officially described or merely followed, which are ineffective or more costly than justified.
2. Duplication of effort by employees or between organizational units.
3. Performance of work which serves little or no useful purpose.
4. Inefficient or uneconomical use of equipment.
5. Overstaffing in relation to work to be done.
6. Faulty buying practices and accumulation of unneeded or excess quantities of property, materials or supplies.
7. Wasteful use of resources.

Efficiency and economy are both relative terms, and it is virtually impossible to give an opinion as to whether an organization has reached the maximum practicable level of either. Therefore, it is not contemplated in these standards that the auditor will be called upon to give such an opinion.

A review of the results of programs or activities shall include inquiry into the results or benefits achieved, and whether the programs or activities are meeting established objectives. (Godick, 1979)

B. NATURE OF OPERATIONAL AUDITING

The nature of operational auditing is illustrated by the viewpoints expressed by senior executives of two large companies who were addressing meetings of their audit staffs.

One said: "I want you to assume that you are the owner of this business, that the business and all of its profits belong to you. Before you recommend a change, before you criticize an operation, ask yourself whether you would do this if the business was yours."

The other said: "I want you auditors to regard your job as that of doing the things for management that the managers would be doing for themselves if they had time to do them."

Both of these views feature the same point, which is that the auditor should be thinking as management thinks. Management has only a secondary interest in protective control. Management's main interest lies in activities; the auditor's observation of these activities and the related controls is the essence of operational auditing. (Cadmus, 1964)

To be effective, operational auditing should be considered as an attitude, a manner of approach, analysis and thought, not as a distinct and separate type of auditing which is characterized by special programs and techniques. A rather common misconception on the part of some internal

auditors is that there is a clear-cut distinction between operational auditing and traditional financial auditing. Auditors look for special manuals which will tell them how to make operational audits, when all that is really necessary is a change in their own manner of approach and analysis. The narrow type of internal auditing will be largely directed to protective analysis and appraisal, often in relation to some set of dogmatic standards of financial control. Operational auditing begins with familiarization with actual operations and operating problems, followed by analysis and appraisal of the controls to assure that they are adequate to protect the business. This, however, is only the beginning of the audit. The examination of the controls becomes a starting point for appraisal of the value of the controls in the operation of the business. (Cadmus, 1964)

If one compares the traditional, financial audit, with the operations audit, the most distinguishing difference between the traditional financial audit and the operations audit is the scope of the engagement. The traditional audit has the objective of determining the fairness of financial statements with a great emphasis on the internal control of the firm. The operations audit includes a review of the objectives of the company or organization, the environment within which it operates, its operating

policies, personnel and even its physical facilities. The operations auditor will use a greater variety of audit tools to obtain the evidence necessary to fulfill the objectives of the audit.

Both types of audits are similar in that the auditor measures against standards in performing the audit. The standards that are used in an operations audit come from two basic sources. These two sources are the individual company and the industry of which the firm is a part. Company standards that are used by operations auditors include lists of objectives, goals, plans, budgets, records of past performance, policies, procedures and directives. Industry sources include industry averages and common business sense. True, these are not always objective standards, but they are standards nonetheless. Because the standards do lack objectivity, the auditor would not accept an engagement to render an opinion to third parties, but subjective judgements can be used to identify possible problem areas. (Flesher, 1977). Table III is a summary of the general characteristics of the two audit concepts.

1. Who Should Conduct an Operations Audit?

There is some question as to who should conduct or perform the operations audit. The first problem is whether the audits should be performed by someone in the organization or by someone external. Second, should operations audit be performed by accountants or by some other professional group?

TABLE III
A COMPARISON OF OPERATIONS AUDIT AND
FINANCIAL AUDIT CONCEPTS
(Norbeck, 1969)

<u>Characteristic</u>	<u>Operations Audit</u>	<u>Financial Audit</u>
1 - Purpose	To aid management to improve company operations	To express an opinion on financial statements as they disclose, do not disclose a true and fair view.
2 - Scope	An operation or function	Fiscal records
3 - Orientation	The operations of the company present and future - management oriented.	A retrospective viewpoint
4 - Frequency	Periodic, but with indefinite timing	Regularly, at least annually
5 - Method	Management Techniques	Auditing standards and procedures
6 - Measurement	Standards for evaluating management performance; management principles	Accounting principles
7 - Necessity	Optional, management prerogative	Legally required
8 - Recipients	Management	Shareholders

The question of internal versus external auditor really depends on the size of the organizations needing the audit, and the amount of resources they have available to support this effort. Many firms could not afford to hire a full-time operations auditor. This solves the problem of the small and medium-sized firms, but what about the large firms who could afford to hire a full-time operations audit staff?

Many feel that the internal auditors role is changing and he/she is the most logical group to perform the operations audit. These individuals take the position that who else but the internal auditor crosses all organizational lines and is exposed to every facet of the business? They are the "eyes and ears of management" and more. The internal auditor is a surveyor and corporate goals are the bench marks. They are concerned with any phase of business activity where he/she can be of service to management. This involves going beyond the financial records to obtain a full understanding of the operations under review. The modern internal auditor should be regarded by operating personnel as a business consultant. In keeping with this image, they frequently act as a teacher, explaining and justifying senior management instructions and regulations and help to establish a general feeling of understanding and acceptance. The internal

audit function is also an integral part of management control. The internal auditor is, therefore, in a position to quickly alert management to problems. Concern is for the protection and effective use of all resources. This includes human as well as physical and financial resources. When conducting an operational audit, the internal auditor diagnoses problem areas and acts as a consultant to resolve these problems. (Tovell, 1976)

Is there any advantage to large firms hiring outside auditors to perform operations audits? Some authorities apparently believe that there is. An article in Forbes discussed the problem in the editor's "Fact and Comment" section:

Why do corporate managers tell all to outside management consultants and clam up with in-house talent trying to do the same sort of analysis? Principally because the outside experts are not seeking to replace all the vice presidents and managers to whom they talk. A called-in management consultant usually settles only for the CEO's job. (Forbes, 1974)

Whatever the reason, an outsider often seems to be able to accomplish something when an equally talented employee of the firm gets nowhere. This is so possibly because a directly measurable outside cost has been incurred.

The other major question with respect to who should perform operations audits is whether such audits should fall within the realm of the accountant. Historically, operations audits have been performed by internal auditors.

Since internal auditors normally have an accounting background, the performance of operations audits has become associated with the accounting profession. Additionally, the term audit has an accounting connotation to it, a fact that has caused some individuals who had little knowledge of operations auditing other than its benefits to call in an accountant when such an audit was desired. Most accounting firms with management services departments feel that operations audit engagements can eventually lead to a profitable management services job.

The performance of operations audits, however, does not necessarily require an accounting background. Some management consulting firms also undertake such engagements; however, most do not since they feel that their real strength and highest billings are in problem solving, not problem locating. (Lindberg and Cohn, 1972)

Some accountants accept such engagements only out of fear that someone else will accept the engagement and use the operations audit as a "foot-in-the-door" technique to try and obtain the opportunity to perform the annual financial audit. It should also be noted that a partial operations audit is usually performed by the CPA firm in performing the financial audit. This mini-operations audit culminates in the management letter that is (supposedly) given to management annually at the completion of the audit. (Doppelt, 1971)

Most national CPA firms have operations audit divisions and many regional firms have also recognized the potential of such engagements. CPA firms should be willing to provide operations audit services at reasonable charges for two reasons. First, the work could be scheduled at any time during the year, thus enabling the firm to make more profitable use of slack periods. Second, the operations audit function could be an adjunct area to the management services division. If the audit client needs help in implementing recommendations contained in the operations audit report, the logical place to look for assistance would be the management services department of the same accounting firm. In fact, the CPA firm might find it advisable to place knowledgeable members of the management services staff on the audit team when an operations audit is being conducted. Not only would the audit be benefited from having the management services people, but the firm would benefit from having the management services people, but the firm would benefit from having the management services staff in continuing contact with the client. There is currently no consensus among CPA firms as to which staff members perform operations audits. Some firms use only auditing personnel, some use only management services staff members, and some firms use a group composed of both types of employees.

Perhaps another definition of operations auditing offers some explanation as to why accountants can perform operations audits equally as well, or better, than other professional groups:

The most important thing to appreciate is that there is no such thing as an operational audit. It is a question of approach and scope - the audit techniques are the same. (Evans, 1969)

As a result, accountants are qualified to perform operations audits because of their training and experience as auditors. Even though what is being audited is not financial, the techniques are the same. Additionally, accountants normally are in a position to have a broad overview of the entire operations of a firm. Therefore, accountants are at least somewhat competent in all aspects of business. Despite the lack of technical skills in a particular operation of business, the accountant can utilize audit training and general business sense to capably perform an operations audit. (Flesher, 1977)

Whatever the reasons, accountants, both internal and external, and management consultants do perform operations audits. The question of who performs such audits is not of singular importance; of additional importance is the increased efficiency that results from an operations audit.

Regardless of who is elected to conduct the operational audit, the operational auditor looks for:

- a. The existence of those general policies which determine the organization requirements - the functions and activities essential to the conduct of the business or government agency.
- b. Indications that people have been designated to perform each of these functions and that the scope of their action and power of decision is both defined and understood.
- c. Predetermined goals or planned accomplishments for each control area, including standards, estimates, budgets, forecasts or other criteria to serve as yardsticks for comparison and evaluation.
- d. An efficient accounting system that accumulates information following the functional organization lines and affords comparison between actual and planned results.
- e. A meaningful system of management information that provides essential and timely decision-making data to all three levels of management - top, middle and supervisory. It should communicate current results as well as future plans.
- f. Control department statistics and financial trends over a period of time that may indicate a deterioration in the effectiveness of controllable activities.
- g. Good communications throughout the whole system of administrative control and evidence that its purpose is being achieved. The object is to determine and transmit what currently should be done and, in the light of later developments, reappraise and communicate the planned course of corrective action to be taken in the future. (Morin, 1974)

2. Benefits of an Operational Audit

Some of the benefits from an operational audit include:

- a. Provide an independent and objective appraisal of the current strengths and weaknesses of the organization.
- b. Stimulate constructive thinking by internal personnel who, while working with the independent auditor or reviewer, are forced to analyze their positions, procedures and environment from a different perspective.
- c. Sometimes provide reassurance to management regarding the overall performance of the organization. It can be comforting to know for instance, that although areas for improvement do exist, the general status of the organization is relatively healthy and consistent with management's evaluation of the state of affairs prior to the operational audit.
- d. Provide insight for management to better understand the "wholeness" of the organization and the interwoven relationships of the various functional areas. (Helps them to see the forest made up of the trees.)
- e. Highlight areas of inefficiency and ineffectiveness and provide recommendations for appropriate remedial measures. (Lets management deal with specifics for improving the organization as opposed to discussing broad generalities.) (Pashke, 1977)

In addition to these benefits, some companies make planned use of operations audits for personnel development. They have a permanent operations audit manager and a nucleus of key personnel. The rest of the staff consists of people who are likely candidates for future reassignment. Staff members assigned to operations audit groups primarily to give them the exposure resulting from working in many phases of the company are moved to positions elsewhere in the company as the need arises. (Lindberg and Cohn, 1972)

Operations auditing offers potential managers the opportunities to obtain a "bird's-eye" view of the organization

and the administrative process that are especially beneficial to operating personnel. Individuals with mostly hands-on experience with new problems and situations is forced by some exposure to operations auditing to make fuller use of their judgement and imagination, and so the company's manpower resource is enriched.

3. Limitation of Operations Auditing

Like any tool, operations auditing must be used properly if results are to be satisfactory. If it is to be used properly, its constraints as well as its capabilities must be understood and heeded. The principal constraints are time, knowledge and cost. Time is a limitation because managers must be advised about the state of affairs in their areas of responsibility promptly enough that they can act effectively. Therefore, audits must be performed regularly and often enough so the problems can be caught before they become big or entrenched. On the other hand, audit engagements must not disrupt either productivity or morale. If they are to be performed with regularity, timeliness and convenience, operations audits cannot be lengthy, drawn-out affairs. (Lindberg and Cohn, 1972)

Knowledge is a constraint because, obviously, no man is expert in all business fields, nor can a company

afford to have on its staff a specialist on every aspect of the business that is to be audited. Necessarily, then, operations audits must be performed by individuals who are trained more fully in auditing than in what is being audited. Among other things, that means that operations audits cannot be used as a vacuum cleaner; realistically, it can be used only to search for major deficiencies and opportunities for improvement. Of course, the operations auditor will not turn away from the small problems and opportunities, but discovering them will be a by-product. In any event, the auditor will detail and seek to prove only the deficiencies and opportunities for improvement that are significant in terms of dollars or effectiveness. (Lindberg and Cohn, 1972)

Together, time and knowledge as constraints produce the third limitation cost. The statement lacks precision, but it must be said that an essential characteristic of operations audit is that it is a low-cost appraisal tool even though no dollar standards are available. When the cost of a single operations audit rises above, say \$5000 or \$6000, it is likely that a good deal more than the discovery and delineation of problems or opportunities for improvement has been undertaken. As a result, auditors are often thrust into the manager's or specialist's province and, despite the greatest precautions, hostility is often stimulated. (Lindberg and Cohn, 1972)

Though subtle and often discreet, an attitude of defensiveness is always present in any type of consulting or audit scenario, and operational audits are no exception. (Katugampola, 1978). What the operational audit can do is to analyze and compare a company's operations, relationships and what makes the company operate as it does. However, the audit cannot implement changes; it can only result in recommendations that may lead to changes.

This matter of an operational audit resulting in a recommendation to the organization is one of considerable debate. As was pointed out by Lindberg and Cohn earlier, the job of the operations auditor is finished when the problem areas have been identified. Desmond Morin agrees with this wholeheartedly. He expressed the fact that an operational audit should not be expected to provide specific solutions to a particular problem or weakness. Experience has invariably shown that the most effective solutions require further analysis, consideration of numerous other factors and research into alternative courses of action. On the other hand, operational auditors should not be reluctant to contribute ideas, based upon their experience, to subsequent discussions of proposed corrective action so long as they are certain that the observational nature of such comments is recognized.

4. Steps in Operational Audit Process

The operational audit process should be performed in a systematic and planned manner. The following are six steps which characterize a typical operational audit.

(Morin, 1974)

- a. Orientation. Tour physical facilities. Study the analysis of past financial trends and forecasted results. Record highlights for further confirmation. Arrange appointments for interviewing key personnel.
- b. Conduct preliminary survey. Complete survey, utilizing appropriate questionnaires and prepare internal memorandum outlining observations in all functional areas and selecting an in-depth area.
- c. Perform in-depth audit. Gather and compile information, views, suggestions, comments, trends and patterns in the more important areas and activities. Carry out a comprehensive audit programme specifically designed for that function. Document and confirm data by interview and examination.
- d. Identify opportunities for improvement. Determine departments and activities requiring attention and, where possible, indicate significance in financial terms. Review findings with staff and with the appropriate levels of management before reporting.
- e. Presentation to client. After making oral presentation to senior executives or officials, prepare a written report. Urge that a timetable be developed, targets set, responsibilities assigned and resources committed to a programme of corrective action. Review and evaluate plan, if requested by client.
- f. Post-audit follow-up. Several months later, make a review to determine the corrective action taken. Prepare an outline of progress to date or apparent reasons for postponement or cancellation of plans. If the internal capacity for correcting and maintaining improvement is limited, due to

other demands on time and lack of experience or competence to handle new concepts or methods, then suggest the guidance of outside specialists. Consider the advisability of blending the operational audit with the audit of financial operations.

5. What Application Does Operations Audits have to the NFP Sector?

The author concludes that operations audits are as much applicable to the NFP sector as they are to the profit or public sector. Of course, not everyone supports the concept of operations auditing. (Santocki, 1974). But despite a few critics, most authorities seem to agree that operations auditing does fill a niche as a valuable management tool. And as the different sectors of the economy continue to grow and expand, the traditional sources of managerial information do not fully meet the needs of management in large organizations. Operations auditing can fill this gap.

With the use of operations auditing, management can maintain its total effectiveness despite the increased complexity of organizations and the constantly increasing demands, both internally within the organization and externally, on managements' time. This is definitely an attribute that every manager of an NFP organization needs.

In Chapter II, it was advocated that the survivability of the NFP sector in the long run will depend in part on the

ability of the leaders/managers of these institutions to adapt and employ current business tools being used in the private sector. This operations audit is such a tool, and the next chapter will examine one possible model that might be used to audit a nonprofit organization.

IV. PRELIMINARY CONSIDERATIONS FOR AN OPERATIONAL AUDIT OF A SMALL NOT-FOR-PROFIT ORGANIZATION

A. INTRODUCTION

Before moving into a discussion of what an NFP operational audit model might look like, it seems appropriate that some discussion be given to the various factors that affect design of an operational audit for a small NFP. After adequate discussion of this subject matter, Chapter V will be devoted to outlining operational audit model "J."

B. FACTORS AFFECTING THE DESIGN OF THE OPERATIONAL AUDIT MODEL FOR A SMALL NFP

In order to bridge the gap in the continuity of information between Chapters II and III, several factors need to be clarified, surfaced and discussed before moving into a discussion of what an operational audit model should look like for a small NFP. Consequently, the first half of this chapter shall be devoted to defining a small NFP, examining the characteristics of a small NFP entrepreneur, discussing special considerations and assumptions concerning the small NFP, and finally, outlining qualifications of the operations auditor of the small NFP.

1. Definition of a Small NFP

Chapter II described at length what a NFP was, and what environment it exists in. The current literature on NFPs seems to make little differentiation between large and small NFPs. So, in order to derive a definition of a small NFP, this section will examine the definition of a small business (for-profit) as described by the Small Business Administration (SBA). From these characteristics of a small business, the author will attempt to abstract a definition of what a small NFP might be.

The SBA was created by Congress as a result of the Small Business Act of 1953. Throughout the history of this country, Congress has considered small business as a vital part of the economy. Since the SBA has been appointed as the "watchdog" of small business, one would expect them to have a very precise definition of what a small business is, with very clear standards. Nothing could be further from the truth. Neither Congress nor the SBA is sure what a "small business" is. Eligibility standards for the SBA's programs vary all over the lot and are subject to change seemingly at a whim. From time to time, the agency has found itself giving money or contracts to some pretty unlikely companies. In 1966, for instance, individuals at American Motors who were eager to compete for government contracts set aside by the SBA persuaded the agency to adopt

a new eligibility standard based on market share. As a result, American Motors, with its five percent of U. S. auto sales, was declared a "small business" for procurement purposes, even though it had revenues of \$879 million that year. (Morner, 1977).

Currently, the SBA defines a small business as one that is independently owned and operated, not dominant in its field and meets employment or sales standards developed by the agency. For most industries, these standards are as follows: (SBA, 1978)

Manufacturing - number of employees may range up to 1,500 depending on the industry in which the applicant is primarily engaged.

Wholesaling - small if yearly sales are not over \$9.5 to \$22 million, depending on the industry.

Services - annual receipts not exceeding \$2 million to \$8 million depending on the industry in which the applicant is primarily engaged.

Retailing - small if annual sales or receipts are not over \$2 to \$7.5 million depending on the industry.

Construction - General Construction: Average annual receipts not exceeding \$9.5 million for three most recently completed fiscal years. Special Trade Construction: Average annual receipts not exceeding \$1 or \$2 million for three most recently completed fiscal years, depending on the industry.

Agriculture - annual receipts not exceeding \$1 million.

The bottom line becomes, ask the nearest SBA\field office to be sure of which standards apply to the type of business one might have an interest in.

Eliminating the public sector, one might define a small NFP as an organization or institution whose primary objective is to supply a socially desirable service without regard for financial gain. Of course, there is no difference between this definition for a small NFP and one for a large NFP. The only real difference between a small NFP and one for a large NFP is their relative size and amount of resources.

Using the SBA's definition of a small private business as a guide, for the purpose of this research effort, one establishes the following standards for a small NFP:

An organization or institution with no more than 500 employees or voluntary workers, who receives no more than \$2 million in annual receipts who has no more than \$4 million in assets whose primary function is to provide a service and whose total cost equals its total revenue over the long run.

2. Characteristics of a Typical Small NFP Manager

The factors affecting the survivability of the NFP sector identified in Chapter II, e. g. poor fiscal management, poor accounting procedures, poor information systems and inability to comprehend threatening external environment, offer even more of a challenge to the small NFP. Because of their limited resources and size, the small NFP seems less equipped to deal with these problem areas. It

is certainly understandable that they are not expected to have the type of resources that a larger NFP might obtain and employ. Consequently, one should expect that they would have even less financial expertise; more problems with understanding why they even need better accounting procedures or information systems; and have little idea of how external factors such as too much government, tax abuses, price discrimination, etc., will eventually affect their organization.

To amplify this point, it might be beneficial to examine the typical small NFP top manager. First of all, a surprising number of top executives of small NFPs are top notched experts who are leaders and innovators in a particular professional area. In many cases, these individuals are or act like the founder of the NFP of which they head. Like small business owners in the private sector, these individuals are characterized by a desire to be their own boss and call their own shots. (Steinmetz, 1968). In every sense of the word, they are entrepreneurs.

As they begin to build and organize their NFPs, one should expect them to surround themselves normally with fellow professionals. Most of these will be people that the entrepreneurs have had contact with during their career and have expressed a desire to work with if they had their own shop, laboratory, organization, etc. Sometimes

this previous working relationship causes problems. One such problem revolves around pay and salary. The entrepreneur is willing to work for less money than earned previously, and expects for others to feel the same way. This problem is amplified as one moves down the chain of command. (Herzlinger, 1979). This may be one explanation as to why some NFPs have problems employing necessary manpower in technical areas on the lower echelon levels.

Normally, one would expect this entrepreneur to have a very limited knowledge of modern business techniques and procedures. So it would seem that individuals would be surrounded with a few individuals with this type of knowledge and expertise, but most of them do not. The reasoning revolves around their perceptions of the financial position of the NFP. Realizing that one does not have to make a profit, one cannot appreciate the need for having a professional managerial type in the top echelon of the organization. The perception held is: after all, how can he have financial difficulties with the tremendous and momentous service he provides through his organization to the public. (Selby, 1978)

If one were to accept this description of a typical small NFP executive, it becomes easier to appreciate the problem areas addressed in Chapter II. Because of their limited resources and staff, they may not even be aware

that they have management oriented problems. This implies that no matter how valuable a tool this operational audit is, or how much it can do for an organization, if the entrepreneur does not recognize that this NFP needs it and can benefit from it, then conducting an operations audit for his organization will serve little purpose. It will never be used. This assumes that it was offered without cost. If a cost was involved, it appears it would never be conducted.

This presents a unique problem to the operations auditor. First, how does one make the service known or "get into the door" of such an organization? Secondly, once inside, how does one conduct this audit? For the purposes of this research effort, the author will not address how to gain access to the small NFP. The author will assume that entry has been granted, now the problem is one of determining what procedures to follow to ensure that the audit proceeds in an orderly fashion and is successful. Success in this case means that the audit has brought to management's attention areas that must be addressed, modified and/or corrected. Management has accepted and implemented corrective action and the organization as a whole has benefited and progressed to do a better job of meeting its' overall objectives.

3. Special Considerations and Assumptions Concerning the Small NFP

In the discussion of the operational audit in Chapter III, there were some basic characteristics or implied assumptions about the relationship of an operations audit and an organizational entity. In this section, clarification and exposition will be given to these areas as well as to look at the special needs of the small NFP in dealing with this operations audit. The fact of the matter is that the literature concerning the operations audit tends to concern large, complex for-profit organizations.

a. Assumptions of Operational Audits in Normal Business Environment

First, the assumption is made that the client and organization understand the framework of an operation audit. This includes understanding the nature of an operational audit, the issues involved, what is happening and what type of problems are most likely to be uncovered. This assumption is certainly acceptable in the case of the large profit oriented business sector, where the Chief Executive is probably a MBA or business professional who is aware of modern management tools, or has someone on the staff who can brief on such matters. In the case of the small NFP manager, this is probably not the case. The

small NFP manager is more likely to be naive, and as discussed earlier, not understand that there are managerial problems.

Secondly, the assumption is made that the profit oriented business will be able to afford a complete, thorough and comprehensive operational audit. This is not so in the case of the small NFP. Even if aware of the value of this management tool, the manager of the small NFP may not have sufficient resources to take advantage of this tool.

Thirdly, the assumption is made that once the audit starts and the auditor begins evaluation and analysis of the data, the client will be able to understand the data results. Therefore, the NFP can use this data in making an intelligent decision as to its applicability to its organization and problems. This may not be the case for the manager of the small NFP. It is very likely that he/she may not understand and appreciate the worthiness of the data provided by the auditor.

Lastly, the assumption is made that the client's system has the capability of implementing worthy assumptions resulting from this audit. In the case of the large for-profit organization staffed with qualified and knowledgeable personnel, this may be true, but in the case of the small NFP managers, one should expect extreme difficulty in

implementing the audit results even where they fully understand them. More than likely, implementation will call for the use of resources that may not be available.

These assumptions will need to be modified as a preface to the design of a small operational audit model. In order to design an effective model, one must overcome these deficiencies, thereby lending credibility to some likelihood of success for the small NFP. Now the special needs of small NFPs in terms of operations audits will be examined.

b. Special Needs of Small NFPs in Terms of Operational Audits

In view of the first assumption, it would seem that such a model must include an educational component at the front end of the model. This would serve the purpose of preparing the clients and their organizations for the audit, as well as exposing them to general problems in the small NFP environment that they may not be familiar with or understand.

There is a need for building a model that is affordable to the small NFP. Affordable in terms of the cost to administer, and in terms of the amount of time needed by the work force and staff to complete the audit. Because of their limited resources and economical constraints, the small NFP may not be able to pay someone who has the

competency that the auditor of a reputable firm has. Are there any other alternatives? Also, they may not be able to afford the luxury of a complete and comprehensive audit. Is it possible to have a model with multiple stages that might allow incremental implementation based on resources available?

For example, a small NFP manager may only want to know the problem areas of the organization. Limited resources do not allow the flexibility of the profit oriented manager. The profit oriented manager may take the attitude of wanting to know how the organization stands in all areas of analysis whether good or bad. But the small NFP might only be able to afford to know what areas need attention. (The manager wants to know those areas that may cause the most damage to the organization if they are not dealt with.)

So what is needed is a flexible model that is both modulative and intergrative. This will allow the small NFP manager the opportunity to elect those portions of the audit most feasible for the organization to apply one stage or program now, another stage later, to apply the complete model, or to just deal with the largest problem.

Lastly, even though the NFP does not have as much funds as the larger organizations, it really needs more than an auditor. In addition to the initial educational phase, the small NFP will need help in understanding

and analyzing the audit findings. Then once the managers understand them, they will need special assistance in implementing the recommendations. Because of the auditor's importance to the success of the operations audit, the next section will discuss at length the optimum qualifications needed in order to audit the small NFPs.

C.. OPERATIONS AUDITOR OF A SMALL NFP

The operations auditors of small NFPs must possess certain technical qualifications that will lead them systematically through the audit process. They must exhibit and strive to meet certain personal qualifications that will facilitate his interacting with the members of the organization being audited. Most importantly, the small NFP will need more than an auditor/accountant. To effectively deal with the special needs of the small NFP, what is needed is a consultant who can implement his recommendations. Since the small NFP client may not understand what is going to happen during the audit or how they should respond, we need to find an auditor/consultant with behavioral science skills in organization development intervention.

1. Technical Qualifications

Earlier in Chapter III, it was discussed who should conduct the operations audit, internal auditor or external

auditor. Because of a limited staff, it would seem that the small NFP would have little choice but to go with the services of an external auditor. Of course, the auditor must be creditable. Without creditability both up and down the chain of command, the audit cannot be successful, or have a high probability of being implemented. (Brink, 1973). Accompanying creditability is objectivity. Objectivity is the whole idea behind having the operations audit in the first place. As such it is paramount that the proposed auditor meet this requirement first. (Brink, 1973)

Technically, the operations auditor must be able and prepared to deal with a wide range of operational situations. For that reason, the auditor will need to have those technical qualifications which are of the broadest possible application. First on the list, therefore, might well be previous involvement in operational activities or at least exposure to them. The activities most useful would vary with the individual company but they will preferably have been in situations where a number of people were involved and where there were problems of administrative direction and control. (Brink, 1973). Secondly, a general useful qualification would be some experience in or understanding of the accounting and financial control processes. (Brink, 1973). This type of qualification does not necessarily involve direct work of an accounting nature but it does at

least involve the kind of exposure which provides a reasonable understanding of this area. This is consistent with the view that the financial control dimension can be an effective starting point for the examination of the broader types of operational control.

2. Personal Qualifications

While the technical qualifications are certainly important, the personal qualifications of the auditor also plays a major role during the audit if the auditor is to be effective. Here one is confronted with a long list of personal qualifications which are normally deemed to be desirable. Also, the problem is further complicated by the fact that the identification and evaluation of these individual qualifications is at best very subjective. Yet, the area is important and one must try to cope with it. Perhaps the most useful approach is to look at these personal qualifications in terms of the major end objectives. Under this approach, one can identify three types of end objectives:

- to achieve a good first impression.
- to develop a more enduring relationship over longer periods of time, and
- to provide an additional basis for sound professional results. (Brink, 1973)

These three end objectives are, of course, very related but they do emphasize particular types of personal qualifications.

a. Achieving a Good First Impression

What can be done to contribute to a successful first impression? To answer, Brink proposes that a combination of personal appearance and the ability of one to capitalize quickly on limited opportunities contributes most toward achieving a good first impression. In respect to personal appearance, there is the desirability of standards of dress and grooming which are at least in the middle range as between extreme conservatism and high style. In respect to the capitalizing of opportunities, one should have the ability to respond effectively to questions and be able to inject himself in the discussion in a manner which demonstrates courtesy and professional competence. In total, the objective sought is to engender respect and confidence as a basis for a proper degree of receptivity for the technical contribution which the auditor is prepared to make. (Brink, 1973)

b. Building Longer Run Relationships

In the long run situation, there is the opportunity to develop effective personal relationships. The major difference here is that there is an ample period

for the demonstration of good qualities through ongoing actions and the testing of those actions. The relationships here can be with personnel in the operational activities being reviewed, and with managerial personnel at all levels. In these kinds of situations, what are the types of personal qualifications that become especially important? In other words, what personal qualifications most contribute to achieving a relationship where the auditor will earn respect and cooperation? In answer to this question, Brink offers the following factors as especially important:

(1) Basic Fairness and Integrity. The kind of response which anyone will make to the auditor is first of all conditioned by a judgment as to whether he can reasonably expect fair treatment. At lower levels, the concern will be whether the auditor will take advantage of his position in any manner, and whether he can be trusted to deal fairly with information made available to him. At higher levels, there will be a similar judgment which then determines how candid that higher level manager will be in his relations with the auditor.

(2) Dedication to Company Interest. Closely related is the concern as to whether the auditor is primarily motivated by what is good for the company. The auditor must demonstrate that he will not be putting special or personal interest ahead of the company welfare.

(3) Reasonable Humility. All of us tend to react in a hostile manner to someone who gives the impression of being too egotistical. More often, no one individual can be that sure of having all of the right answers, and a reasonable recognition of those limitations is both more realistic and more likely to impress the people one is coming into contact with.

(4) Professional Poise. People respect a person who appears to be competent and who conducts himself in a professional manner. This also combines a lack of aloofness with the avoidance of being too forward or excessively friendly.

(5) Empathy. This is the ability to project oneself to an understanding of how the other person feels. It involves courtesy and consideration for how what one is saying or doing is affecting the other person. It reflects a proper degree of general interest in people, to which all of us respond favorably. On the other hand, it can stop short of being overly solicitous or insincere.

(6) Role Consistency. The persons with whom the auditor has contact have a set of expectations as to what the role of the auditor should be. To the extent that those expectations are appropriate, they need to be confirmed, and to the extent that they are inappropriate, they have to be modified carefully by the actions of the auditor. In all cases, however, the role played by the auditor must be stable and consistent. He needs to build a feeling of confidence in the eyes of the people with whom he associates.

c. Building a Basis for Professional Results

All of the foregoing are important in establishing an effective relationship with the people with whom the auditor associates. There are in addition, however, a group of personal qualifications which bear more directly on his competence in a strictly professional sense. These personal qualifications relate particularly to the way the auditor conducts the actual auditing activities. Brink offers the following personal qualifications: (Brink, Cashin and Witt, 1973)

(1) Curiosity. The auditor should have a natural curiosity to probe for possible underlying explanations. He should not be satisfied with generalizations or types of explanations which ignore important considerations.

(2) Critical Attitude. The quality here is not to be critical in the sense of giving criticism, but critical in the sense of making careful judgments about the various matters with which the auditor is involved.

It is an extension of the above mentioned curiosity with a high standard for the adequacy of information.

(3) Alertness. The auditor needs to be alert to all possible sources of information which may in some way bear on the issues under consideration. He utilizes the innumerable interrelationships which always come with individual types of developments.

(4) Persistence. The auditor does not give up easily when he is blocked in some way in his pursuit of needed information or for possible solutions of problems which need answers. He needs to have a genuine motivation to get good answers.

(5) Energy. Energy is in a sense the backup quality for persistence. It is the force which keeps us going when others would give up and settle for whatever has already been found. It is a combination of temperment, dedication and good health.

(6) Self Confidence. Self confidence generates confidence in others. It is the inward conviction that one knows what one is doing and that it is the right thing to do. It is backed up both by knowledge and the belief that one is doing the best thing possible.

(7) Courage. Closely related to self confidence is courage. The quality of courage, however, goes further and involves the willingness to stand one's ground in the face of pressures and risks. It is a personal qualification which indeed, adds status to the auditor and to his effectiveness, especially when that courage has been demonstrated. All auditors will face this problem at one time or another.

(8) Ability to Make Sound Judgments. All of us are beset with conflicting factors of all types as we deal with individual questions. Judgment is the ability to calmly weigh these conflicting factors, including the impact of the varying time dimensions, and to come out with sound judgments. Here the requirement is not for a perfect record, but rather how many more correct judgments there are versus the ones which were in error.

(9) Integrity. We repeat integrity here because of its basic importance. It is the quality which leads others to rely on the findings and conclusions of the

auditors. This reliance includes the belief in the professional competence and fairness and honesty with which the material has been presented. It is, indeed, a major basis for any continuing good professional relationship.

Victor Z. Brink, James A. Cashin and Herbert Witt formulated this list of personal qualifications with the internal auditor in mind. With the limited resources normally available to the small NFP manager, it is very unlikely that one will find an internal auditor on the staff of a small NFP. Yet, in order for an external auditor to successfully deal with the small NFP environment, these factors become important. Because in the limited time that the auditor is exposed to the small NFP organization, he or she should also strive to achieve a good first impression; should develop an enduring relationship of trust and understanding; and must build a relationship with the client that will yield positive and professional results.

3. Management Consultant with OD Intervention Capabilities

In earlier sections of this research effort, it was discussed the fact that managers and supervisory personnel were more likely to be naive and not understand why they should need an operational audit; they would not understand the audit process, nor the recommendations being offered to solve problem areas, nor would they understand how to fully implement recommendations once they have been

made. From these points, one can assume that the auditor will probably have to effect a change in the organization to better prepare the members of the organization for the audit. Consequently, another qualification needed by the auditor of a small NFP would be to perform tasks normally associated with one who professes to be a management consultant. Management consulting is the professional service performed by specially trained and experienced persons in helping managers identify and solve managerial and operating problems of the various institutions of our society, in recommending practical solutions to these problems, and helping to implement them when necessary. This professional service focuses on improving the managerial, operating and economic performance of these institutions.

The management consultant counsels the chief executive and other members of management on managerial and operating problems of the enterprise. Activity is not confined to solving these problems in a purely theoretical, abstract or technical sense. The problems with which the consultant deals are action-oriented, and thinking must be directed toward improved managerial and economic performance and results for the client. This must include the creation of understanding and commitment toward a particular change and methods whereby it can become integral to the client's organization. The consultant must urge and persuade the client and, when necessary, help develop a sound course of

action. The change program must include emotional and value as well as informational elements for successful implementation. Relying on rational persuasion is not sufficient. Most organizations possess the knowledge to cure many of their problems; the rub is utilization. (Higdon, 1969)

So, in order for the auditor to be effective, it is necessary for him to be knowledgeable in approaches to organizational change. Harold J. Leavitt suggests that an organization can be changed by changing its structure, its technology and/or its people. Changing the organizations' structure involves rearranging its internal systems, such as its lines of communication, work flow or managerial hierarchy. Changing the organization's technology means altering its equipment, engineering processes, research techniques or production methods. Changing the organization's people involves changing the selection, training, relationships, attitude or roles of organization members. (Leavitt, 1964)

Both the technical and structural approaches attempt to improve organizational performance by changing the work situation. They are based on the assumption that creating an appropriate work situation will cause employee behavior to become more productive. The people approaches, on the other hand, attempt to change directly the behavior of employees by focusing on their attitudes and skills.

These approaches are based on the assumption that improving the attitudes and skills of employees will, in turn, cause employees to perform more effectively. The new attitudes and skills may also encourage the employees to take the lead in changing the organization's structure and technology, leading to still more improvement in organizational performance. (Leavitt, 1964)

The auditor will find these change approaches particularly useful in solving immediate problems in an organization. Say for example, the auditor is called by a small NTP manager who for whatever reason does not want the application of the entire audit model. He or she simply wants the auditor to identify the largest problem, and then assist in turning it around.

Organization development (OD) is another change approach. It evolved from the use of techniques from psychology, sociology and anthropology in solving organizational problems. The term itself is attributed to Robert Blake, Herb Shepard and Jane Mouten during their early work at ESSO Corporation, now EXXON. OD is not designed to solve a single or temporary problem in the organization. It is a longer-term, more encompassing change approach designed to move the entire organization to a higher level of function, that is, to improve greatly the performance and satisfaction of organization members. While organizational development may frequently include structural,

technological and people changes, it actually seeks to make more fundamental changes in the way the organization operates. (French and Bell, 1973)

Organizational development has been defined by Michael E. McGill as:

"A conscious, planned process of developing an organization's capabilities so that it can attain and sustain an optimum level of performance as measured by efficiency, effectiveness and health. Operationally, OD is a normative process of addressing the questions: 'Where are we?' 'Where do we want to be?' 'How do we get from where we are to where we want to be?' This process is undertaken by members of the organization using a variety of techniques, often in collaboration with a behavioral science consultant." (McGill, 1977)

The relationship between auditing a small NFP organization and OD may not be readily apparent. An examination of how OD change agents go about finding out what aspects of the organization need to be improved and how the organization can be helped to make these improvements may clarify this incongruence.

This finding out process is commonly referred to as action research. Action research involves: (1) a preliminary diagnosis of the problem by OD change agents; (2) data gathering to support or disprove the diagnosis; (3) feedback of the data to organization members; (4) exploration of the data by organization members; (5) planning of appropriate action; and (6) taking appropriate action.

Careful scrutiny of items one through three in the above paragraph, and the six steps of a typical operational audit discussed in Chapter III, will verify the contention here that an operational audit of any sized organization is simply the top portion of an organization development program. Because of its potential usefulness to the auditor, it is appropriate here to outline the major characteristics of an OD process. There are eight major characteristics that are typical of most OD programs. (French and Bell, 1973)

1. OD is an ongoing, dynamic process. OD does not represent a quick, easy solution to an organization's problems. The OD process actually requires a considerable investment in time and money. (The organizations that use OD are therefore likely to be at least moderately successful.) OD practitioners may initially suggest a strategy for change to organization members. That strategy will be laboriously tested against the feelings and experiences of organization members and modified accordingly. Eventually, a final change strategy will emerge. Implementing that strategy may take several years.

2. OD is a form of applied behavioral science. OD change agents consciously attempt to apply research findings from the behavioral sciences, including psychology, sociology and political science. For example, if the organization's reward system is seen as ineffective, they may apply the finding that in certain situations, money incentives will promote productivity.

3. OD is a normative, reeducative process. OD practitioners share certain normative assumptions and values about how organization members should relate to each other. For example, they believe in open communication between organizational groups and in subordinate participation in problem solving. OD practitioners also believe that meaningful change is unlikely to take place unless the traditional assumptions and norms of

organization members are replaced by more appropriate norms and assumptions. Thus, OD change agents will work together with organization members to explore a variety of new attitudes, values and ways of relating to others.

4. OD takes a systems view of organizations. As described in Chapter II, a systems approach to organizations sees the various parts of the organization as being interrelated. OD practitioners are aware that organizational problems may have many causes, each requiring attention. They must also take into account the fact that a change in one part of the organization may affect the other parts. Thus, OD is usually implemented on an organization-wide basis.

5. OD actions are data-based. The actions or interventions of OD change agents are not based on what top managers see as the organization's problems or even on the initial assumptions made by the change agents themselves. Instead, the interventions are based on the change agents' research into the feelings and opinions of organization members about the organization's problems. Through attitude surveys, for example, the OD change agents may find that members resent the organization's authoritarian climate or its promotion system.

6. OD is based on people's experiences. OD practitioners do not base their actions on abstract management theories but on the real, day-to-day experiences of organization members. For example, they will frequently schedule a meeting after a work activity and invite members to discuss what they liked and disliked about that activity, and how it was performed.

7. OD emphasizes goal setting and planning. As we frequently mentioned in our chapters on planning, the setting of specific, measurable goals motivates organization members and helps focus their activities. OD change agents help members learn how to set personal goals and work toward achieving them. For example, an individual's goals might be to "reduce conflict in my interactions with others and earn a promotion within three years." OD change agents may also work with managers and subordinates to help set up an MBO program to improve organizational performance.

8. OD focuses on intact work teams. OD practitioners believe that intact work teams provide the most effective means of achieving organizational goals. They also believe that such teams are most satisfying to their members. Most OD change agents, therefore, concentrate their activities on improving the performance and relationships within work teams.

In the last two decades, a lot of research has gone into formulating the theory and practice of OD, and throughout this time, many well known scholars and foundations have demonstrated OD's proven and potential contribution to individual and organizational efficiency and effectiveness. (McGill, 1977) Also, because of the efforts of these institutions and individuals, OD has evolved as a very useful modern management technique for organizations of all types and sizes. So, where applicable, the auditor of the small NFP may find it more beneficial to the client to make use of the entire OD process rather than employ just the top half as typified by the usual operations audit process.

4. Who Can Do the Job?

The expression "applicant must be able to leap tall buildings with a single bound, stop bullets with his teeth, run faster than a speeding locomotive, and still work for the cost of a hamburger" is quite appropo in the case of small NFPs. The special needs of the small NFP coupled with the necessity for low cost means that most accounting firms, consulting firms, university professors and management advisory services will not meet the requirements.

Consequently, the recent graduate of a masters in business administration program (MBA) may be the most desirable candidate. If nothing else, he/she is bound to be the most affordable, as compared to an auditing or consulting firm.

The author feels that such an individual with the help of some low cost technicians could do a good job of administering an operational audit. Most MBA programs around the United States equip its graduates with a broad base of knowledge and skills. Armed with a background of managerial accounting, financial management, operations research, statistics, systems analysis and production and material management; as well as some behavioral and interpersonal exposure to management, psychology and organizational development; this candidate is as current as one should be with the use of modern business tools and techniques being used in the business world today. So with a desire to perform the audit, a recent MBA graduate should be very capable for this assignment.

This chapter examined the preliminary considerations necessary for successful interface with the small NFP sector. In addition, discussion was given to the characteristics of small NFP managers, and the personal attributes necessary for an auditor to successfully conduct an operational audit in a small NFP setting. The next chapter will be devoted to outlining and discussing the stages of operational audit model "J."

V. OPERATIONAL AUDIT MODEL "J"

In the last chapter, great length was given to deciphering the special needs of managers of small NFPs in respect to their ability to cooperate with and make use of an operations auditor and his audit findings. Also reviewed were the qualifications needed to conduct such an audit. With these assumptions and variables in mind, an audit model has been designed that is intended to satisfy the needs of the small NFP. Many of the concepts or relationships expressed here are those of the author. Specific references to professional works are made where applicable.

A. DESIGN OF OPERATION AUDIT MODEL "J" FOR SMALL NFPs

Reading through this model one must keep in mind that the approach here is that the operations audit is nothing more than a financially flavored OD intervention technique, and the auditor is nothing more than a change agent. As such, it is assumed that the criteria for effective interventions applies not only to traditional behavioral science OD approaches, but also has applicability for the operations audit. Given that this is the case, then it might be beneficial to review the criteria for successful OD interventions.

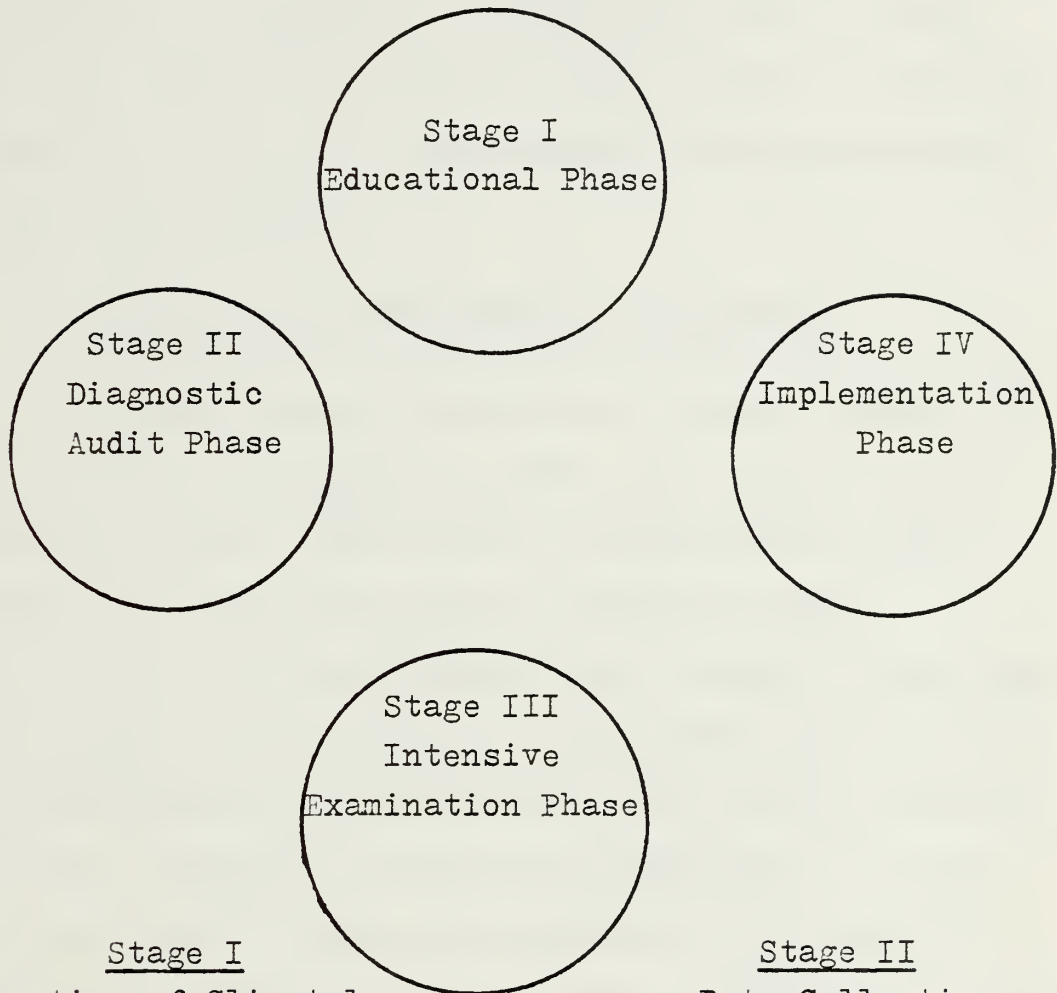
In the field of organizational development today, the criteria most generally accepted by managers and consultants alike seem to be those suggested by Chris Argyris:¹ To be effective, OD must generate valid information, ensure free informed choice and promote internal commitment. Argyris contends, and many others in the field concur, that these are essential processes and must be fulfilled if any organizational change is to be effective, regardless of the organization or substantive issues involved. These criteria are central to effective intervention. (McGill, 1977). Also this criteria is essential to the achievement of a successful operations audit using Operational Audit Model "J." (Exhibit A)

B. STAGE I - EDUCATIONAL PHASE

Ideally, the top managers and their department heads will fully appreciate the purpose of the operational auditing function. Hopefully, they will welcome the auditor, cooperate and help in every way they can. These managers may be somewhat apprehensive about errors in procedure that may be turned up, but they are not really upset by that possibility. They will, in fact, look upon the audit as an important learning experience.

¹Michael E. McGill in his book, Organizational Development for Operating Managers, cites Chris Argyris as the originator of these suggestions, however, no reference is given.

EXHIBIT A
OPERATIONAL AUDIT MODEL "J"



Stage I
Education of Clientele
Education of Auditor

Stage III
Intensive Analysis
Data Collection
Data Interpretation
Recommendations and
Reports

Stage II
Data Collection
Analysis
Summarization Data
Report

Stage IV
Implementation/
Assistance
Monitoring/Evaluation
Disengagement/
Follow-up

Since this is not likely to be the attitude of the small NFP, an audit model addressing their needs must include some type of educational component at the front end of the model to prepare the organization for the audit. Also, this educational component might serve the function of updating them to the environmental problems impacting on their organization.

1. Education and Observation of Clientele

If readiness and environmental educations are the objectives of the operations audit, does one get there during this phase? What kinds of things must be done, and who should take the lead in conducting them?

Well, the stage should be set during the pre-audit brief between the auditor and the top executive. Successful relationships between the client and auditor requires some early definition of roles and procedures. At this point, the formal terms and conditions of the contract between the auditor and client should be reviewed, and any questionable areas resolved. The contract normally specifies such items as: (Harvey and Brown, 1976)

- The point of contact. Whom in the client system will the change agent be contacting and who will be contacting him?
- The role of the change agent. Is he to be an expert, a process helper, etc.?

- The fees. The amount the consultant charges for his services varies, depending on the financial status of the client system and the amount of time devoted to consulting.
- The schedule. For example, "the objectives can be accomplished over an anticipated two-year program devoting five days of consulting time per month." The schedule might also include a tentative list of activities and meetings.
- The anticipated results. The outcome should be stated as specifically as possible; however, some consultants warn against providing any guarantee of value to the organization as this tends to put the responsibility for change with the consultant instead of with the client. The change agent may promise to do his best to develop a valid diagnosis of organization problems, and he might suggest in a very general way, areas of change that he expects would develop.
- The operating ground rules. Such ground rules could include, but are not limited, to the following:
 - a. The point of contact, which will usually include the top man.
 - b. The requirements of the organization members, such as being prepared for meetings.
 - c. The confidentiality of consulting information.
 - d. The process role, rather than having an expert coming in to define problems and implement solutions.

While these are not all the factors involved in an agreement, they have been presented by Donald F. Harvey and Donald R. Brown as guidelines for the beginning OD practitioner. For the auditors of a small NFP, it may serve them well as a check list of things to discuss with their clients during the pre-audit briefing. (Harvey and Brown, 1976)

After the operating ground rules have been formalized, the auditor should lead the client into a general discussion

of the top managers' perceptions of the organization. The questions asked must be open-ended questions which will not allow the auditor to evaluate the client system's readiness for the audit as well as the client's ability to handle change. Some managers will exhibit a flexible attitude when confronted with a changing environment, while others' attitudes may become very rigid and totally resistant. In order to conduct a successful operations audit, the auditor must be sensitive to the top man's tolerance for ambiguity.

Also, the auditor must keep in mind the previous discussion on first impressions. First impressions are very important in setting the climate for the entire audit period; the auditor must understand that just as they are evaluating the clients, the clients are also evaluating them. Matters such as objectivity, credibility and all the other factors discussed previously, concerning the auditors qualifications, must certainly be given some thought and attention.

Once adequate interaction has been given to discussions with the top manager, it is now time for a seminar or training session with the department managers and supervisors of the organization. The intent is to invite all parties involved in the audit to a meeting prior to conducting the actual audit. Parties attending this meeting

should have been discussed during the pre-audit meeting. In addition to educating the client system to operational auditing, this meeting serves a great psychological purpose in that each person being audited is given an opportunity to aid in developing the audit plan. By doing so, one becomes a part of the audit team rather than merely a subject of the audit. One helps the auditor in a constructive manner to concentrate in those areas which can benefit most from an objective appraisal. Many times the auditee is aware of problem areas which have not been eliminated because of lack of support from internal management. The auditees can now gain support for their position, if justified, by using the audit to one's advantage.

The auditor should also use this meeting as a means of opening up communications with the clientele. When properly established, this line of communication can be the key to providing adequate corrective action to problems which are noted during the audit. The clientele of the audit is much more willing to act if it is felt if that one played a part in finding and solving the problems. (Guck, 1974)

2. Auditor Education

The educational process of the auditor begins as soon as the idea they intend to work with a particular organization is accepted, and it continues throughout the

entire audit period. It is very important that he begins to become acquainted with the type of organization and environment of the client as soon as the job is accepted. If, during the pre-audit brief or meeting with member of the client system, one exhibits a total lack of knowledge about the client system, the auditee may lose credibility, thus making him or her ineffective as an auditor.

What the auditor must do then is to become familiar with the NFP being audited. In some cases this may require a research of current business literature in order to build a foundation necessary to allow comparative analysis of one organization to another. For as the auditor moves through the audit process, it is a must that one be familiar with the current research changes in production management, marketing, financial management and behavior management skills. Also of importance is the auditor's knowledge of change, and the implementation of change. Regardless of how innovative the knowledge, if the organization cannot transfer this technology to its people in a way that encourages them to use the new knowledge, then this technology and the audit serve little purpose.

Another way that auditors educate themselves is through actually touring the physical facilities of the organization. Just walking through a plant, chatting casually with the employees, will give the auditor an

appreciation of problem areas that may be brought up later. For example, if the audit is covering a manufacturing operation, a walk through the plant with the managers or their assistants is essential. The auditor can then visualize and inquire about problems of physical operation - such as handling of scrap, receipt of materials or a pallet load of material collecting dust over in a corner.

Familiarization then is the key to the auditor's education. The importance of familiarization cannot be overstressed. The auditor must have a working knowledge of the actual operations and problems. Unless one knows what is being done, how it is being done and why it is being done in the attainment of departmental and company objectives, one cannot make a competent audit. The auditee cannot fulfill the assignment of appraisal of controls, unless he or she knows what is being controlled. (Cadmus, 1964)

When the auditor believes that there is an adequate understanding of objectives and problems, he or she then proceeds to examine the controls which establish and maintain the environment within which management operates, in other words, the controls which management uses to govern its operations and attain its objectives can be examined.

According to Cadmus, first comes organization structure. Here the auditor should be interested in

learning the assignments of authority and responsibility, the related organizational checks and balances, the relationships with other departments and between subordinate groups within the department. If an organization chart is not available, the auditor should prepare one to use as a guide during the audit.

Next comes the review of the policies and procedures which govern the work of the department. Here this discussion may be with a departmental administrative supervisor, who will probably be more familiar with detailed procedures than will the operating department head. Written policies and procedures are a necessity in practically all operations. Through them, individual employees know what they have to do and how they should do it, and those directly responsible and others are informed as to the scope of responsibility and methods of operation. Written procedures establish standards for performance of work. When a violation occurs, it provides a definite signal for further investigation. Something may be unusual about a particular transaction, or the procedure or policy itself may be incomplete or incorrect. (Cadmus, 1964)

If there are no written policies or procedures, the auditor should learn from the managers and supervisors the standards that govern the activities which are being

audited. Also of note would be how well does the higher manager's perception of what the policies are really takes place on the lower levels of the organization.

The process of familiarization is one that will continue throughout the audit; as the auditor learns more and more about the details of the operation in the course of the examination and appraisals. However, as has been mentioned, the initial familiarization is an essential phase of STAGE I of the operational audit of the NFP. For without an adequate working knowledge of the objectives and controls of the operating department, the auditor cannot make an intelligent audit.

C. STAGE II - DIAGNOSTIC AUDIT PHASE

Put simply, the Diagnostic Audit Phase is a second educational process within the "J" model. Its principal method of collection is the survey. This method is expected to be a relatively fast process for gathering information on an activity or program. Its main purposes are (1) identifying problem areas warranting additional review, and (2) obtaining information for use in planning and performing the detailed review work to follow. Since a survey permits an orderly approach to planning and carrying out audit work, it can be an effective tool for

applying scarce auditing resources where they will do the most good. It will also reduce the time required to make the detailed review. (Raaum, 1979)

The extensiveness of the survey will depend on the auditor's training, experience, and how much is already known about the organization and the area being examined. The more the auditor knows, the less survey work that should have to be done.

1. Survey Techniques for Data Collection

There are many techniques by which the auditor can identify problem areas warranting more penetrating examination. Here are some examples that are recommendable for collecting data for a small FNP:

a. Questionnaires

Raising a good question is often the key to uncovering a hidden problem or revealing a sound solution. As has been made abundantly clear, the operations auditor is primarily a question "man" and not an answer "man!" Accordingly, questionnaires are an effective tool for gathering information about the organization.

The main value of a questionnaire lies in the conversation and information it produces, not in the questionnaire itself. For example, the questionnaire does not have the objective value; the responses cannot be totaled

up to some kind of quantitative measure. The effectiveness of a company's activities can no more be evaluated by adding up the yeses and nos of a questionnaire than the soundness of an apple can be measured with a pair of calipers.

(Lindberg and Cohn, 1972)

b. Interviews/Discussions

Interviewing is one of the most widely used data-gathering techniques. It has the advantage of being more direct, personal and flexible than other survey techniques. Interviewing usually begins with the initial intervention and continues throughout the entire audit process. Data-gathering interviews usually last approximately 45 minutes to an hour, and the purpose is to get the interviewee to talk freely about things that are important and to share perceptions in an honest and straightforward manner. (Harvey and Brown, 1976). During the diagnostic audit phase, the auditor should concentrate on general type of questions designed to amplify and supplement the questionnaires. Later, during the intensive audit phase, more discussion will be given to how the auditor of the small NFP should conduct the interview. Certainly, these comments are appropriate any time the auditor personally communicates with the clientele.

c. Review of Management Reports

It should not come as a surprise that very few small NFPs will have a formal reporting system, but if

there are reports, they should be used. However, the auditor must keep in mind that reports showing operating performance will cover a variety of subjects, ranging from those which depict total department performance for general management down to detailed listings of such items as material withdrawals or overtime premium pay. In familiarizing one with reports, Cadmus points out that the auditor should inquire as to:

- (1) Who receives the report?
- (2) What does - or can - the recipient do about it?
- (3) What arbitrary allocations are used?
- (4) How well does it coordinate with other reports?
- (5) Does it duplicate other available information?
- (6) How valid and usable are the comparisons shown in the reports?
- (7) Do the reports meet management needs?
- (8) What would the result be if the report was discontinued?

Always keep in mind that reports are usable in control only when they are prompt, fair, concise and complete. The auditor should have these factors constantly in mind as he or she becomes familiar with the report structure of the operating department. (Cadmus, 1964)

d. Test Examinations of Transactions

A useful way to obtain a practical working insight into the efficiency of procedures is to pursue a number of transactions pertaining to the organization's operations completely from beginning to end. This kind of testing will provide the auditor with valuable information on the way the organization's business is actually transacted, on the usefulness (or pertinence) of prescribed procedures, on the capabilities of personnel involved, and on weaknesses in procedures or practices which could represent a drain on the organization's resources. (Morse, 1971)

2. Areas of Analysis

Because of the different make-up and design of different small NFPs, it is possible to give a synopsis of each area of operation that should be reviewed. Instead, the author of this dissertation has identified what were considered the ten most common and critical areas of a small NFP based on the literature reviewed. These areas are;

(a) Planning and Budgeting, (b) Information and Communication, (c) Personnel, (d) Accounting, (e) Manufacturing, Production and Operations, (f) Cost and Pricing, (g) Purchasing, (h) Marketing, (i) Customer Relations, and (j) Merchandise Inventory Control. .

The discussion here is designed only to give the auditor a clue of important functions that the auditor should look for when observing each area.

a. Planning and Budgeting

By definition, to plan means to make a detailed program of action involving the section of objectives, policies, and procedures. There is usually little confusion or difficulty as to what is meant by planning, and most managers including small NFP managers will agree as to the importance of planning. Unfortunately, even though there is much statistical evidence which supports the fact that planning should, and does, pay off in successful operations, lip service is often all that is paid to that need by many small business managers. (Steinmetz, 1968).

So the auditor conducting an operation audit of the small NFP must be sensitive to certain deficiencies in the planning process that might alert him or her to be concerned. The following are some of the prime deficiencies a good auditor should be on the look out for when examining the planning processes. The auditor must be careful of a process:

- (1) Which suffers from a lack of genuine interest or support from top management.
- (2) That diverts too much of top management time.

(3) That is done for the approvers rather than the doers.

(4) Which allow plans to be formulated solely by top management, then they are forced on the people at middle and lower levels who have to carry out the actions called for.

(5) Which become traditional or habitual, consequently no one uses them, and they are neatly filed away until next period.

(6) That allow plans to be too general; they have insufficient detail to permit the establishment of reasonable controls. (Stoner, 1978)

A budget is a plan expressed in monetary terms. The auditor of the small NFP must correlate the plan with budget, in order to determine the usefulness of these two instruments. If there is little correlation, then this area must be identified as the first "red flare" area.¹

Budgeting is an important part of the management control process in any organization, but it is even more important in a nonprofit organization than a profit-oriented company. One reason is that in a profit-oriented company, particularly a manufacturing company, a large

¹Red flare areas being areas that need further investigation and looking into.

fraction of the costs are engineered costs; for example, the amount of labor and the quantity of material required to manufacture products are determined within rather close limits by the specifications of the products and of the manufacturing process. Consequently, little can be done to affect these costs during the budgeting process. By contrast, in most nonprofit organizations, a large fraction of the costs are discretionary; that is, the amount that is to be spent can be varied within wide limits according to decisions made by management. The most important of these decisions are made during the budgeting process. (Anthony and Herzlinger, 1975)

So the objectives of the auditor in reviewing this function should be to ascertain that necessary, timely and accurate information is available about the amounts of resources required to fulfill the objectives of the total organization, and that information being used is accurate and is being used properly to ensure that resources are available when needed.

b. Information and Communication

Evaluating the information-communication systems begins with understanding what information is and why it and its communication is needed. Information takes many forms; it can be raw or processed data or factual, subjective or deductive material. C. E. Shannon, one of the founders

of information theory, probably enunciated the most fruitful idea about it when he said that information is that which resolves uncertainty.

The need for information is common to all business, but it begins to assume critical significance when a company grows beyond the administrative capacity of one individual. If a highly differentiated company is to be run effectively, there must be a basis for focusing effort. The prime means is through the downward communication of corporate plans and directives and the upward communication of information that requires management action.

The problem generated by the information explosion that has taken place in all but the smallest companies is that decision makers cannot possibly digest information fast enough. It is commonly held that an information-communication system constitutes a problem when an organization is unable to furnish the executive with the up-to-date, pertinent information required to plan, control and manage resources in a cost effective manner. But just as great a problem exists when the executive receives more information than can be handled or receives material in an unrelated or disorganized fashion. (Lindberg and Cohn, 1972)

A prime consideration to the operations auditor of the small NFP is that an information system cannot be successful unless it is designed for the direct needs of the user and with his or her full involvement and participation. Effective communication is extremely important for managers for two reasons. First, communication is the necessary process by which the management functions of planning, organizing, leading and controlling are accomplished. Second, communication is the activity to which managers devote an overwhelming proportion of their time.

The process of communication makes it possible for managers to carry out their task responsibilities. Information must be communicated to managers so that they will have a basis for planning. The plans must then be communicated to others in order to be carried out. Organizing requires communicating with people about their job assignments. Leading requires managers to communicate with subordinates so that group goals can be achieved. Written or verbal communications are an essential part of controlling. In short, managers do not manage in isolation; they can carry out their management functions only by interacting with and communicating with others. The communication process is thus the foundation upon which the management functions depend.

So one of the important variables as to whether or not this function might be considered "red flare"

or not would be dependent on how the individual managers need for information is being satisfied. There is no easy way to assess this fit between information needs and data supplied other than to just ask for relevant inputs directly from internal managers. But the auditor must ensure that the managers of the NFP have proper access to factual data, that is correct and complete, that is readily available, and in the right quantity.

The auditor must keep an eye out for informational "bottlenecks" or reservoirs of data that are neatly collected and tucked away for safekeeping by an isolated group or individual. Little information in a small NFP should be closely held; so if the audit reveals a tendency to treat a great many things as confidential, a major problem area has possibly been unciphered.

Because information confers power on its possessor, information itself can be a barrier to effective communication. Information tends to flow in direct proportion to its unimportance; people tend to hang on to information that has importance of one kind or another and pass along information that has little value. (Lindberg and Cohn, 1972). Because of this, the auditor should be concerned with the quality of information passing up and down the chain-of-command. Quality here referring to the freshness and readiness of the information shared.

c. Personnel

In the small NFP, it will be very likely that we will find a personnel function that is separate and distinct from the other departments or divisions. If one assumes that the whole can be no better than its parts, then it should be safe to say that personnel will make or break any organization regardless of its size. Because no organization can be better than the collective efforts of its human resources, this function cannot be safely ignored.

In regard to approaching this area, it is very critical for the small NFP auditor to identify who in the organization is responsible. Usually, the auditor will find that the top executive will reserve this function for themselves, or their "right-hand" assistants. But it is certain that someone is handling the continuing tasks of finding people, training them, paying them, handling their problems, selecting them for promotion, evaluating them and terminating them.

A check list such as the one outlined in Exhibit B will provide a quick familiarity with personnel activities necessary for any organization. This check list should serve only as a guide for the small NFP auditor. It is not expected that the auditor would find a formally structured program dealing with each of the subject areas of the

EXHIBIT B

PERSONNEL MANAGEMENT CHECKLIST¹

1. EMPLOYMENT

Selection

- Requisition (including job specifications)
- Recruitment (use of personnel agencies, advertising, executive search, colleges; specialized and executive recruitment; minority employment)

Interviews

Tests

Reference checks

Physical examinations

Job offer and acceptance

Placement

- Induction (plus new employee orientation); legal contracts, bonds, patent agreements

Counseling

Transfers

Promotions

Termination

- Exit interviews, checklist

- Severance pay

Records

Reports

2. WORKING CONDITIONS

Sanitation

Ventilation

Lighting

Heating

Rest periods

Food Service

3. COMPENSATION

Job descriptions

Wage scales

Incentives (management by objectives)

Bonuses

Profit sharing

Executive compensation

Periodic performance review

¹Taken from Lindberg and Cohn, 1975

EXHIBIT B
(continued)

4. TRAINING AND EDUCATION
 - On-the-job training
 - Apprenticeship
 - Conferences
 - Technical Training
 - Management training and development
 - Library
 - Manuals
 - Bulletins
5. HEALTH
 - Examinations
 - First Aid
6. SAFETY
 - Inspection
 - Education
 - Programs
 - Workmen's Compensation
7. WELFARE AND SERVICES
 - Insurance
 - Unemployment
 - Hospital
 - Life
 - Others
 - Retirement and pensions
 - Bonds
 - Social activities
 - Employee purchases
 - Transportation
 - Suggestion system
8. EMPLOYEE RELATIONS
 - Grievance procedure
 - Female workers
 - Handicapped workers
 - Minority groups
 - Contract negotiation
 - Policy indoctrination
9. SECURITY
 - Procedures
 - Guard service
 - Investigations

EXHIBIT B
(continued)

10. RESEARCH

- Job analysis
- Turnover
- Absenteeism
- Accidents and accident reports
- Employee morale
- Wages and living costs
- Community-industry wage list

11. PLANNING

- Staffing requirements
- Training program
- Departmental budget(s)

check list, but the auditor should find someone in the organization who is responsible and knowledgeable in these areas.

d. Accounting

Today almost all organizations are required to have their financial statements reviewed and certified by a Certified Public Accountant for accuracy and completeness. If it is not required by law (city, county, state, federal), then the board of directors may require it in their charter. The first thing the auditor of the small NFP should do when examining this area is to review the financial statements forwarded to external sources or certified by a Certified Public Accountant. If a NFP does not employ the services of a Certified Public Accountant to at least annually review the financial records, then it should be recommended highly that the organization institute such a system immediately.

The purpose of the small NFP auditor looking at the accounting system is to ensure that accounting data is collected efficiently, accurately and timely. The auditor should review how the data was used and whether or not it aided the decision making process. Then look at how well the organization controls its assets, particularly, how it manages its cash.

A good means of testing the efficiency of the accounting system is to analyze its reports. There really

should be no need for operating personnel to carry "little black books" as sources of information if the accounting system is providing useful information to all levels of the organization. But what often happens is that even though the reporting system is given to lower echelon managers, it is often not designed for their needs, or they have not been adequately trained to use it.

The following hints offered by Halsey Broom and Justin Longenecker (1975) seem useful while evaluating the record-keeping system of a small NFP:

(1) The record-keeping system should yield an accurate, thorough picture of operating results.

(2) The records should permit a quick comparison of current data with prior years' operating results and with budgetary goals.

(3) The record-keeping system should provide suitable financial statements for use by management and submission to prospective creditors.

(4) The record-keeping system should permit prompt filing of reports and tax returns to regulatory and tax collecting agencies of the government.

(5) The record-keeping system should reveal all possible employee frauds, thefts, waste and record-keeping errors.

If a small NFP is going to fail, the first signs of deterioration and ineptness will be the way it

manages its cash. Cash management is one operating area in which efficiency and economy become one and the same thing. If money is not spent as efficiently as possible, it is not spent as economically as possible. (Pomeranz, 1976)

The small NFP auditor must ensure that appropriate department heads and managers understand the necessity for cash flow analysis. Cash flow must be planned to ensure that cash is available during periods of possible shortage. The effects of inefficient cash management may often seem to be negligible, but in agencies receiving and disbursing millions of dollars a year, poor cash management can result in serious losses.

In a time of inflation as exists today, emphasis must be placed on practical steps to counter at least some of the effects of inflation. Effective anti-inflationary systems must start by seeking to improve or protect the cash position. For example, reducing monetary items, such as cash or accounts receivable, is crucial in minimizing the effects of eroding purchasing power. Other ways to lessen the effects of inflation are to improve the yields on investments, speed up the flow of receipts and delay the flow of disbursements. There are many other ways to reduce the effects of inflation and this is one area that the auditor of the small NFP should examine in depth in order to be able to offer viable suggestions appropriate for the specific small NFP being reviewed.

e. Manufacturing/Production/Operations

Manufacturing and production processes involve the conversion of materials, products and components into a different or new product. Many small NFPs find themselves in the manufacturing business, in which case the main activity is subjecting the supply and flow of materials to the operations of labor and machines. On the other hand, the basic activity of other NFPs is service, in which case, the main activity consists of scheduling and dispatching labor and as necessary, equipment and materials.

In either case the auditor of the small NFP must give special concern to the following areas:

- Short-term and long-term forecasting of resource requirements
- The scheduling of production or service needs
- Determining economic lot sizes for manufacturing
- Determining optimum availability of a service for a particular time
- Machine loading and scheduling
- Manpower planning and training needs
- Equipment and facilities planning (including maintenance and replacement plans)
- Storage of raw materials
- Quality control and inspection systems
- Measuring system to reflect the adequacy of service
- Warehousing and finished-stock control

Obviously, all of these areas will not exist in every small NFP, but this list should serve as a guide for the auditor to use during the audit.

f. Cost and Pricing

Certainly there is much overlap in the areas that the auditor is examining. Cost and pricing is one such area. It is virtually impossible for the operating managers to do a good job of costing and pricing their goods or services when they are not furnished accurate, timely and complete data from the accounting system.

As important as cost is to the overall survival of an organization, it seems impossible that many managers operate with only the thinnest knowledge of their costs. These managers set their prices based on subjective appraisals rather than factual cost information. But, pricing can be effective only when cost information is sound. (Lindberg and Cohn, 1972)

Most of the literature on costing systems describe three basic costing systems:

(1) The Job Cost System. This system is used when product costs can reliably be identified, as in the production of tailored or customized products. All labor and material costs are charged directly to the product, and indirect costs are allocated by a predetermined overhead rate.

(2) The Process Cost System. This system is used when products are manufactured in large batches or by mass production. Costs incurred in a department are averaged over the units produced. Products still in process at the end of a period are recomputed into equivalent finished products. The total cost charged to a department is divided by total computed production of the department. This then would give an average cost per unit for the period.

(3) The Standard Cost System. Standard costs are the planned costs of a product under current or anticipated operating conditions. They are based on normal or attainable conditions of efficiency and volume.

So with this information in mind, the auditor of the small NFP should be looking for a costing system that relates in some way to one of these basic systems. If none exist, then as a function of the consulting role, the auditor should begin to survey the operation under scrutiny to see which system would be more effective. For without a good cost system, it is impossible for the NFP to know where it will break even in regards to profit and loss.

Break-even point represents a point where the volume of sales for a business entity allows that entity to cover both its variable and fixed cost. A good cost

system will give management a break-even figure from which to work, and ascertaining that figure should be one of the auditor's most important functions while examining this cost and pricing area.

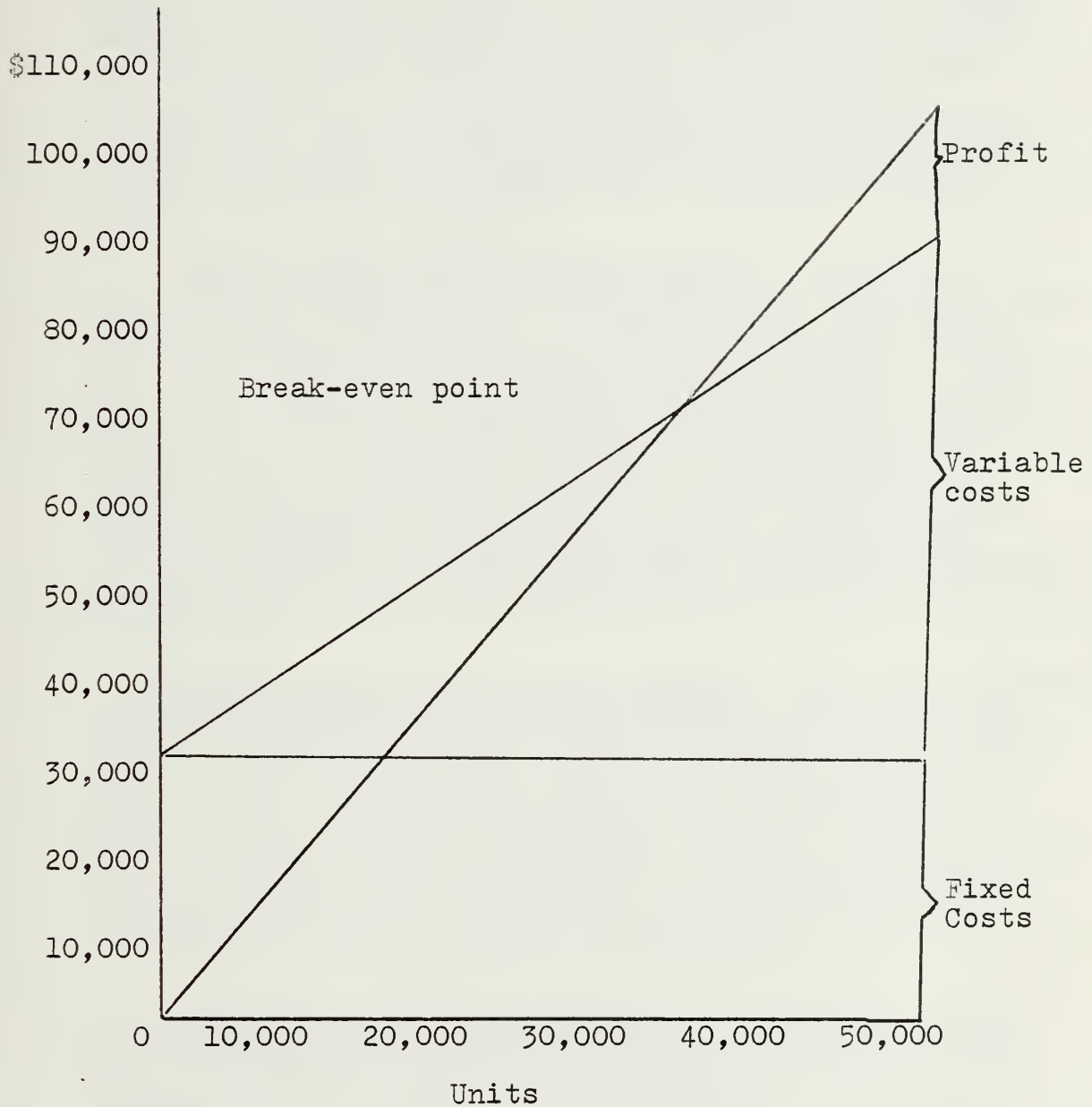
The most commonly utilized tool for break-even analysis is a simple break-even chart. The auditor should examine the chart if one exists to see if the manager understands what it means to the organization and where the NFP honestly stands. If a break-even chart does not exist, then the auditor should provide assistance in preparing one. A sample break-even chart is presented as Exhibit C.

Pricing is the second part of the area of observation. A good pricing policy is just as important as a good cost system, but it also depends very heavily on a thorough knowledge of the cost of the service or product needing to be priced. Correct pricing makes the essential difference between success and failure in business. (Lindberg and Cohn, 1972). A pricing system should be based on its ability to respond quickly and sensitively to changes in demand, competition and supply in the marketplace.

The auditor of a small NFP must be searching for the pricing strategy employed by the NFP being audited. Roy Lindberg and Theodore Cohn (1972) discussed several

EXHIBIT C

BREAK-EVEN CHART (PROFIT GRAPH)



Source: Accounting Principle and Control, Lawrence Vance, Holt, Rinehart and Winston, Inc., 1960

strategies on which to base prices that are applicable to the small NFP:

1. Strategy of meeting competitors' prices. Many smaller companies are not in a position to materially affect the level of prices in their particular industry because of either superior prices or marketing. They are forced, therefore, to adopt a follow-the-leader pricing policy. If intelligently administered and coupled with effective control over manufacturing costs, that can be an advantage to a smaller concern because it frees the company from extensive record keeping and data analysis.

2. Pricing below competitors' prices. A policy of lower-than-average prices is often chosen as the alternative to sales promotions. A manufacturer may reason that the elasticity of demand for this product is such the lower prices will result in greater volume, which, in turn will result in lower unit cost and higher profits. However, if he has miscalculated and the elasticity of demand for his product is small, underpricing may invite retaliation and a price level at which no one can make profits. Underpricing may be accomplished indirectly with services, free deals, special discounts, freight absorption, premiums, product warrants and other techniques.

3. Pricing above competitors' prices. Quality assurance, responsibility of the sell and service, and other non-price considerations may support pricing above the market. The strategy often denotes a higher standard of quality and craftsmanship, but the firm employing it must be in effective competition with the other concerns handling similar products. In the long run, the firm that uses the higher-price strategy must produce a superior product. Under these circumstances, the strategy may yield exceptional profits.

4. Pricing to deter emergence of competition. Protection through patents or copyrights or the development and maintenance of significant product advantages can often deter the emergence of competition. But, when a company does not have the capability of developing entirely new products or so improving old ones that they become recognizably superior to others, it may have to price its products to make it disadvantageous for other firms to enter its market.

Profits seem like a topic inappropriate for discussion around a NFP, but it should be kept in mind that the entire organization may be required to show a slight profit in the short run to allow adjustments from a period where it may have incurred some losses. Or on the other hand, many NFPs today have related industries or departments that maximize their profits in order to offset other sections of the NFP. Because of this, it is important that the auditor ensure that the client understands the importance of a pricing system that is adaptable and flexible enough to meet changes in economic conditions, industry changes and product potential. For the usefulness of a sound pricing system will be its ability to promote the long-range welfare of the organization.

g. Purchasing

The importance of this function is generally recognized and can be reflected in the way larger organizations tend to centralize this function. As the small NFP grows, someone should be looking to see if it would be cost effective to centralize certain purchasing requirements. Presently, the auditor should be looking at how efficient does the entity acquire the things they need for the organization.

h. Marketing

Traditionally, the one detriment the NFPs have ignored is the usefulness of marketing. To many administrators

of NFPs, marketing has the image of being exclusively a tool for use in commercial businesses and one highly identified with selling and promoting. Because of this, they feel uncomfortable about marketing being used for their organizations. But the basic reason a nonprofit organization should be interested in formal marketing principles is that they will enable the organization to be more effective in achieving its objectives. Organizations in a free society depend upon voluntary exchanges to accomplish their objectives. Resources must be attracted, employees must be stimulated, customers must be found. The designing of proper incentives is a key step in stimulating these exchanges. Marketing is the applied science most concerned with managing exchanges effectively and efficiently. (Kotler, 1975). According to Kotler, marketing is designed to render two specific benefits to its practitioners:

(1) Improved Satisfaction of the Target Market.

Marketing places a great emphasis on measuring the needs and desires of the target market. If the organization has not done this, or does not do it well, the clients are apt to be poorly served. This results in high customer turnover or bad word-of-mouth which ultimately hurts the organization. The apathy or low morale of many college students, for example, stems from the failure of some

universities to be sufficiently sensitive to their needs and desires. Such universities ultimately find it difficult to attract new students and adequate alumni support.

(2) Improved Efficiency in Marketing Activities.

Marketing places a great emphasis on the scientific formulation and handling of activities involving product development, pricing, communication and distribution. Many nonprofit organizations make these decisions with insufficient knowledge resulting in either more cost for the given impact or less impact for the given cost. Because the funds of nonprofit organizations are often inadequate and tenuous, it behooves the administrator to achieve the maximum efficiency and effectiveness in marketing activities.

So if the small NFP is to stay in step with the other business entities of our economy, some attention should rightfully be given to marketing in those situations where it seems appropriate. Once again, the auditor is more likely to be an excellent source for the introduction of these marketing principles.

i. Customer Relations

Some might consider customer relations to be an extension of marketing which might be proper. But, customer relations are something that tend to be overlooked. Some managers seem to be guided by the quality and technique

used in producing a product, or they rely on the qualifications of service personnel rather than the customers' responses to the product service.

In recent years, consumer interests have received widespread attention. The author's research indicates that the consumer is vastly more critical and powerful than he was a few years ago. Much of the consumer criticism has been directed against manufacturers, such as automobile manufacturers, who allegedly have produced unsafe cars. Service firms are not immune, however, and face the same type of rising expectations. Weak service that might have been tolerated a few years earlier is no longer acceptable. The consumer voice is today being heard in government, and the cause of the consumer is politically popular. Some states have started licensing TV repairmen and auto repair shops. Congress has conducted hearings on the auto repair industry. Elimination of fraud and provision of efficient service are imperative if small service firms are to prosper and to avoid further governmental regulation. (Broom and Longenecker, 1975)

Each small NFP in business to offer a service must keep in mind that its customers will judge them by the promptness and quality of its service. For nothing is more annoying to some customers than being promised a service which fails to come or arrive at the appointed

time. Given reasonably prompt service, it is the firm which renders the best service that prospers and grows. Service is all that a service firm has to sell. If its service is substandard, there is no real hope for the organization to survive or succeed.

So, in addition to observing the track record of a small NFPs customer relations efforts in terms of promptness and quality of service, the auditor should look for what type of feedback mechanisms exist to keep the NFP managers appraised of the sentiments and impressions of their regular customers.

j. Merchandise Inventory Control

Inventory control and materials management are critical factors in the operation of a small business. To be sure, in some businesses, particularly those concerned with service functions, inventory may be a negligible factor of importance. However, in many small businesses such as manufacturing, retail store and wholesale operations, inventory costs can be a sizable element in the success or failure of the operation. Therefore, any small businessman who has sizable investment in inventory should be aware of the proper mechanics of inventory control and materials management. (Steinmetz, 1968)

Because of the importance of inventory control and materials management to the small business (includes

small NFP), it is necessary for the auditor of the small NFP to look for objectives of inventory control. This will allow him or her to gauge the effectiveness of how well this organization controls its inventory, as well as point out to the client the pitfalls of poor inventory management. Five objectives are cited: (Steinmetz, 1968)

(1) Physical Protection. Physical protection of the items of inventory is one of the fundamental objectives of inventory control. Inventory and materials, like cash, machinery or equipment, are valuable business assets and must be protected from the ravages of theft, shrinkage and deterioration. To help ensure the physical protection of inventory and material, it is recommended that a physical inventory be taken at least once a year and preferably quarterly or semi-annually. Such physical inventory should not only include the counting of case lots or boxes, but should include a spot check of the merchandise which is packed in the boxes or bins.

(2) Investment Control. It should be obvious that one of the major objectives of inventory control is to reduce the investment tied up in inventory to the barest practical minimum. This objective not only reduces the investment of funds in inventory but it has the corollary advantages of providing more working capital to small entities, decreasing the amount of storage space required for the inventory, reducing insurance premiums and taxes, and lessening the loss to inventory items because of deterioration, obsolescence, shrinkage or breakage.

While the desirability of minimizing the investment tied up in inventory becomes blatantly obvious, one word of caution must be made. Although the small entities are well advised to minimize the amount of funds tied up in inventory, they must be cautious not to keep too little inventory, and consider the advantages of any special prices or deals which might be arranged by buying in quantity and receiving quantity or other discounts. The objective of investment control in inventory management is not

one of merely minimizing costs. Rather, it is one of optimizing the expenditure of funds. Too little inventory may mean lost sales, while too high inventories may mean high cost of capital.

(3) Material and Product Flow Control. The third objective of inventory control is to have perpetual or continual control of material or product flow. This objective of inventory control is particularly crucial to the small business. Continuous operations are essential to economical operations, be it in a warehouse, a manufacturing plant, a retail store, or a service operation. Any delay in operations because of lack of materials or parts can be a serious matter. Business may be lost and profits unrealized. This is always an undesirable situation, but for the small businessman who depends so often on the return business of a satisfied customer, it can result in success or failure of the business.

Therefore, it is imperative that in endeavoring to maximize profits, the small entity has some idea of the whereabouts and amounts of materials.

(4) Cost Analysis. The fourth objective of inventory control is that of cost analysis. Having an adequate control system over inventory can provide a wealth of useful information for cost and administrative control purposes. For example, keeping adequate control over all material purchased, material in process, finished products on hand, and amount of scrappage or wastage can be extremely important to the small manufacturer in determining the costs of manufacturing. Likewise, records of what is in the stock room, what is on the shelf and what has been sold can be immensely useful to the small retailer in determining how much of what to reorder, rather than just guessing that one should reorder some of this and some of that. Further, like the manufacturer, the small retailer can use such records to determine how much it costs to handle a particular item of merchandise.

(5) Promoting Sales. Another primary objective of accurate inventory control techniques is that of promoting sales. Although this objective is not always apparent, it is extremely important to small entities and their success. The fact is that greater sales are achieved if goods are available when they are demanded. A customer comes into a store and wants to buy a product today, not two weeks from now; a purchasing agent orders

merchandise from a company salesman for delivery on a specific day, not "sometime in the future." Lack of merchandise can, in short, result in lost sales. More importantly than the lost sale may be a lost customer, which in turn will ultimately reduce future sales. Therefore, accurate inventory records can ensure that the manufacturer has the right product produced when it is needed, or the retailer has the demanded product in stock.

This objective means small entities should optimize inventory in order to maximize sales, rather than minimize inventories in an effort to reduce costs. However, there is a danger here; many retailers can be led down the primrose path of believing that they should never be out of any product; manufacturers can be led to believe that they must always have the product ready to ship; wholesalers may think that they have the requested product in stock; and, service people may believe that they must be able to instantaneously provide any and all kinds of services demanded. These notions are, of course, fallacious. There are numerous times when the cost for the inability to provide a service or supply a product is less than that of overstocking. What is required is that the small businessman determine what items are important enough to always have on hand and what items do not warrant constant supply. In short, the small entity should arrange the stocks and supplies so that the entity is never out of high-demand items, is only occasionally out of often-demanded items, but seldom stocks low-demand items. Here again, the entity must refer to his inventory control records to determine the demand frequency of his inventory. That is, he should know for an average week which items are sold in large amounts, which are sold in moderation, and which items have not sold at all. If such records are kept, he will be able to maximize sales by always having the high-demand items on hand, while at the same time, inventory costs will be reduced because he will not tie up his working capital in seldom-demanded items.

Although Steinmetz applies these objectives to small businesses per se, the author feels that they are certainly appropriate for the NFP engaged in a business-oriented enterprise. As such, the auditor should evaluate

this area of the audit with these objectives in mind as to the kinds of procedures the small NFP would need in order to have a good inventory control program.

Certainly there is nothing magical about the auditor limiting the review to these areas, nor is there a correlation between the amount of discussion given in this research effort and the amount of attention that should be given to these areas. The above ten areas are expounded on here merely as a guide to what the auditor of a small NFP will find relevant to the audit. The amount of time spent in each area should be solely dependent on the subjective appraisal of the "red flare" areas the author identifies as needing further attention.

3. Summarizing Survey Results

Now that data has been collected from each of the areas above, the next step is to examine the data and arrange it into some workable and logical order. Remembering that the purpose of the collection of data is to give the organization a better understanding of potential "red flare" areas. Consequently, timely communication with the top managers on the survey's results is the most essential part of the audit survey.

It is a good idea to prepare a summary at the completion of a survey to facilitate communication and provide

a record for future reference. The auditor should include an explanation of what was done, the auditor's observations and recommendations for further work. When the survey results dictate further review work, the auditor should point out:

- The problems and the rationale for examining them in greater depth.
- Suggested audit work steps and reasons for them.
- Pertinent information developed during the survey phase.
- Preliminary estimates of time and resource requirements, particularly for personnel.
- Target date for completing the review and reporting phases.

(Scantlebury and Raaum, 1978)

4. Educating Clientele on Results of Survey

Earlier, the limitations of the small NFP in terms of being able to comprehend the language and purpose of the operational audit was discussed. One of the assumptions was that more than likely additional education or training would be necessary to acquaint the small organization with the tools and techniques being used during the audit. If this is a correct assumption, then it also seems to follow from this that once the auditor has collected the applicable data, that some effort to explain, in as simple terms possible, how the data was derived will be

needed. The how is certainly important, but it is not as important as the simple realization on the auditor's part that something will have to be done to allow his client the ability to digest the data. In other words, the auditor must be sensitive to this need and let the circumstance dictate the actions.

No matter how one chooses to simplify the survey results, the auditor of the small NFP must make it clear to the client what the ramifications will be if nothing is done versus the ramifications if everything is done. For at this point, the client has a decision to make as to whether the NFP can afford the resources to continue the audit. This point makes a very convenient place for the client to disengage the audit effort. For in the case of some small NFP without the resources for a full comprehensive audit effort, they may be very happy to have had a third party relay to them those areas that the organization should examine further.

If the small NFP has the resources, time and money, to continue, then the auditor must now offer a plan of attack for the areas that must be looked at in depth. With this plan of attack should be an honest appraisal of whose time will be needed and when; and how the auditor intends to proceed.

D. STAGE III - INTENSIVE EXAMINATION PHASE

If the decision is made to continue the audit, then the auditor will begin the intensive examination phase. This phase is simply a narrower concentration of effort toward those areas already identified during the diagnostic phase. During the phase, the auditor will resort mostly to interviews and personal observation as data collection devices. As such, additional attention will be given to the interview and how the auditor should conduct himself.

1. Develop a Plan

The first step during this phase is the preparation of a plan of attack. The auditor and the person who acts as the point of contact for the audit will have to agree upon a plan. Since the basic area has been identified, the discussion should center around who the auditor would like to talk with and what documents should be reviewed. This phase will be particularly difficult to structure because there are so many variables that it would be hard to establish a firm questionnaire as to what questions the auditor should ask. Instead, the auditor must keep in mind that the objective during Phase III is to find support for the "hunches" that have surfaced with the questionnaire and the first set of interviews. Because the audit of the small NFP is a sequential set of never ending queries:

What is being done, and should it be done at all? Where is it being done and should it be done elsewhere? Why is it being done, and has the circumstance which caused its being done in the first place changed? Who is doing it, and might it be done better by someone else? How is it being done and might it be done better?

2. Data Collection

The employees and supervisors of the NFP being audited know the answers to these important questions. They know what the important problems are and which areas need closer attention. (Hodges, 1978). So the task of the auditor is how does one get them to openly talk about these "red flare" areas.

Spencer Hodges proposes that if the auditor can create a nonthreatening environment, he or she will succeed in getting the employees to be open and honest in their conversation. He suggests two ways to do this that apply very well to the small NFP environment. The most important thing is to choose the right audit objective. The traditional audit approach emphasizes evaluation of past performance. This places people on the defensive and closes off communication. People do not like to be criticized. When positive solution-oriented thinking and a broader

perspective to improve future operations are emphasized, individuals are more likely to open up.

A second factor in creating an open climate is the attitude of the auditor. If auditors authoritatively emphasize the fact that they represent top management and are sent to monitor compliance with established policies and procedures, cooperation will be minimal. If, on the other hand, auditors show a genuine concern for people and make an effort to understand their problems, the auditees will open up.

A good auditor will use open-ended questions during this phase like: What do you do on your job? What takes up most of your time? - depends on whether this is a reinterview or first interview. Since these questions are easy to answer, the auditee gains confidence and develops a sense of rapport with the auditor. Now the auditor can get into more specific questions. However, it is not good to interrupt or criticize their responses. It is good to let them ramble. If their logic is hard to follow, ask more specific questions. If the answers are still confused, try to clear up the confusion by asking additional questions.

Questions can be used in a nonthreatening manner to involve people, to get them to provide information, and questions help one understand what people are thinking. In the process, one may obtain new insights. When the

auditor draws the person out by listening to his or her view, these views are reinforced. In fact, the views may firm up to a point where the person develops the confidence to act. This type of listening reinforcement is one of the most powerful tools auditors have at their disposal for creating change. (Hodges, 1978)

3. Data Analysis and Interpretation

Once the auditor has collected the data during this phase through mostly interviewing and observation of procedures and records, the next step is: How is the data analyzed and interpreted? One should expect that the small NFP will have few written instructions and procedures. So in order for the auditor to have something to compare the data to in establishing a subjective opinion as to its value or meaning, the auditor will need something to compare it against.

One solution proposed is a comparison of the small NFP's operating or management practices with "preferred practices." A preferred practice is one that has been found successful, or a criterion that has been found optimal, through experience with and study of, many entities over a period of years. Thus, the failure to adhere to a preferred practice is an indication that resources may be, or at least may have been, wasted or inefficiently used. (Pomeranz, 1976)

So, as the auditors compare the data against their knowledge of preferred practices, he or she will have some that compare favorably. Others will not compare favorably and will require further action on their part. This action revolves around assessing the significance of the deficiency. This can be done by systematically analyzing what can be described as the significant effects of the failure to follow a practice that is considered preferred. (Pomeranz, 1976)

The most obvious way to interpret this for easy understanding by the managers of the small NFP is to qualify these deficiencies into something that everyone will understand, such as dollars! Most of the decisions a manager makes revolve around how much of the organizations resources in terms of dollars certain actions will involve. So presenting these deficiencies in terms of dollars will facilitate a comparison by the manager of the cost to correct the deficiency versus the cost of not taking any action at all. This may not be possible in every instance, but where it is possible, even when it is just an estimate, it should be used.

The process of expressing the effect of an operational controls deficiency in terms of money is called "dollarization." Basically, this technique enables a presentation of the cost of resources wasted through failure

to adhere to a preferred practice. Frequently, in an organization, noncompliance with preferred practices is obvious, yet no corrective action is initiated until dollarization brings into focus the full impact of the deficiency.

4. Recommendations and Report

The next step in this phase is to report major deficiencies and make recommendations to top management of how the organization may be improved. This is the time when misunderstandings are resolved, solutions to problems are agreed upon, and positive action is assured to correct weaknesses in the NFP. The auditors recommendations will be of little value if the problems are not presented to those persons with the authority to institute corrective actions, or the recommendations are not understood by those capable of effecting a change. So, prior to the preparation of the report to the party who initiated the audit, the auditor must be concerned with educating the clientele to the audit findings and recommendations.

Hopefully, the dollarization process will assist the auditor in presenting the recommendations in a way that they would be comprehended and accepted for action. The point though, is that the auditor must be very sensitive to this issue of educating the client, and ensure that

things are kept as simple as possible. For example, if the auditor is analyzing a capital budgeting problem, it might be simpler for the client if techniques are used that are more familiar to non-MBAs. So rather than using say the internal rate of return method, it may be more convenient for the client if the auditor would use the pay-back or cash flow method.

The report itself should be as short as possible. It should identify only the major areas worthy of top management attention; minor problems should be discussed and settled at the lowest possible supervisory level; and any finding or recommendation that affects an operating supervisor should be brought to his or her attention before it appears in the report. As far as possible, the auditor should secure agreement on recommendations from operating management and present them as joint recommendations. If it is not possible to have an agreement, then any and all criticism should be supported by a constructive recommendation and supporting factual information. Lastly, the terms used in the report should be those terms in which the operating manager is accustomed to thinking. (Cadmus, 1964)

E. STAGE IV - IMPLEMENTATION/ASSISTANCE PHASE

There are several ways that the organization can get to this point of the audit. First, the auditor enters into

the small NFP to conduct an audit and is told that this is the problem, here are two recommendations for solving the problem. If the auditor concurs, then one of the alternatives is selected and the audit moves directly to the implementation phase. Secondly, one can progress to this phase after completion of the diagnostic phase, assuming that top management agrees with solutions to problem areas. Thirdly, the audit may progress through all of the phases.

1. Who Should Perform Implementation/Assistance Phase?

In any of these cases, the management report and recommendations still apply. Also, in any of these cases, it is not mandatory that the auditor brought in be present during the implementation phase. The idea is that the amount of services received by the small NFP will be dependent on its own problem areas and the amount of resources it can afford to spend on this venture. The NFP has three choices concerning who should implement the recommendations:

a. Clients can implement the recommendations themselves. The advantage to this alternative would be the savings of resources and a more flexible time frame for implementing the recommendation. The disadvantage of the client implementing the recommendation is that the client organization may not have a person in the organization capable of handling this type of audit.

b. Someone outside of the organization other than the present auditor might assist in implementing the recommendations. For example, the recommendation should call for a specialist, e. g. time and motion expert, financial auditor, engineer, an OD consultant, or a management services firm. The advantage here is that the organization acquires the services of an expert in a particular field. The disadvantage may be the costs of acquiring an outside source. Other difficulties include finding an expert with time parameters coinciding with the organizations need, and getting the expert to agree on the recommendation and method of implementation.

c. Client and auditor implementing recommendations together. The disadvantage here is the cost of retaining the auditor. To be properly implemented into an operating system, a given recommendation could take months or years before it is fully implemented and observed by all concerned. Just how long should the auditor/consultant stay around?

The advantage of the same auditor implementing the recommendations is that the clientele have hopefully built up a relationship with this individual, believe in him or her, and are more likely to assist in ensuring that the recommendation work; especially when the auditor has given them appropriate credit for their recommendations.

Given these alternative ways of implementation, the role of the initial auditor of the small NFP is different in each situation. If the NFP is going to implement the recommendations without further assistance, then the auditor's duties are finished once the recommendations and suggestions for implementation are made. If an outside source is going to be used, or if the organization does not have the resources and know how to find an expert, then the organization should negotiate a contract with the auditor who in turn should solicit and hire a specialist for the organization.

If the NFP and the auditor are to work together towards implementation, then the auditor will find the role has changed completely to that of a consultant. Now it may be appropriate to set up seminars or workshops around those areas needing improvement. Maybe some one-on-one training should be conducted with certain managers that need a tailored program designed for their own departmental needs. Maybe more sophisticated OD techniques are needed such as T-group learning, managerial grid programs, management by objectives programs, team building, or intergroup development programs. It all depends on the needs of the organization, and what recommendations have been made by the auditor.

2. Monitoring/Evaluation

Once the auditor/consultant begins the implementation of an action program, the next step is to monitor the results and stabilize the situation once desired changes are achieved. This step concerns the assessment of the effectiveness of change strategies in attaining stated objectives. Each step of an OD program needs to be monitored to gain feedback on members' reaction to the change efforts. The system members need to know the results of change efforts in order to determine whether they ought to modify, continue or discontinue the activities. Once disequilibrium has been corrected and a change program implemented and monitored, means must be devised to make sure the new behavior is stabilized. If this is not done, the tendency is for the system to regress to previous ineffective modes or states. The client system needs to develop the capability to maintain innovation without outside support. (Harvey and Brown, 1976)

3. Disengagement and Follow-up

The last step in the implementation/assistance phase is a process whereby the auditor with the aid of the client decides how to conclude or add the finishing touches to the operational audit. In applying these finishing touches to the operational audit of the small NFP, there

are three concepts the auditor must understand: (1) Disengagement, (2) Termination, and (3) Follow-up.

Disengagement is a withdrawal of the auditor/consultant from the clients system which leads to termination. It occurs when either the consultant feels that little more can be accomplished or members of the client system feel able to continue on their own. The auditor/consultant of the small NFP must know when to begin the process of disengagement from the client system. As the OD program stabilizes, the need for the change agent or consultant should decrease. When dealing with the small NFP, the consultant must be especially sensitive to disengagement because it is very possible that the client may become overly dependent on the consultant. This would be more harmful than good because it would interrupt the normal operational and administrative flow of the organization.

Termination is the complete break of relations between the auditor and the client system. A quick break is not advisable for small NFPs because they usually do not have the personnel in-house to successfully continue the change effort. And even in the case where the client has to terminate because of lack of funds, or the auditor fails to meet specified objectives, an abrupt break may cause "shock" to the client system. For example, supervisors

may feel that because the auditor was terminated abruptly the comments or recommendations were poor. Many of these individuals will feel that they have sacrificed their time to participate in the audit process, and because of this they expect some recommendations and advice in return on how to do their jobs more efficiently. If the auditor leaves without providing such information, they will feel cheated or short changed. So in order to avoid this and keep the employees morale stable, it is advisable that a lot of thought be given to how the employees might react before executing an abrupt termination.

The need for a follow-up systems is paramount in the audit of a small NFP. For if the small NFP will have difficulty comprehending the recommendations, they will probably have difficulty understanding when and if the implementation phase has been successful. When this is likely, it is recommended that the auditor/consultant give thought to a continued involvement and a gradual termination. The auditor and the client should agree on some sort of post audit follow-up. It could be as informal as a phone call, or the consultant being available for emergency help; or, it could be as formal as the auditor/consultant agreeing to a special follow-up consultation.

A special follow-up consultation might be scheduled for several months or so after the operational audit. The

purpose of this follow-up would be to review the corrective action taken to date. The data collected here by the auditor would serve as a feedback loop leading the auditor back to Stage III of the audit model. The auditor would enter the model with an outline of the progress made to date and a list of reasons for postponement or cancellation of recommended plans. If from the personal observation and interviews during follow-up, one is of the opinion that the organization will continue to have trouble implementing certain recommendations, then it may be appropriate for the consultant to assist the organization for hopefully some short period of time in order to turn certain areas around, and get the organization back on track.

In the next chapter, the author takes the four phases of Operational Audit Model "J" and applies these to a small NFP, Monterey Bay Academy. Acting as the auditor, the author works through the phases of the audit model and makes recommendations as to how Monterey Bay Academy may improve its industrial activities.

VI. TEST CASE

A. PERSPECTIVE

This chapter represents the actual application of operational audit model "J" to a small NFP. Its purpose is to test and demonstrate the practical usefulness of the model in a real life situation. The organization being audited is the Monterey Bay Academy (MBA), and the author of this thesis performed the role of auditor/consultant.

Because the author performed the audit using a personally designed model, one might expect that it may be difficult for the author to maintain total objectivity, especially since the comments and assessments made are those seen solely through the eyes of the auditor. As such, it is important for the reader to note that this chapter is more subjective than the previous chapters.

B. APPLICATION OF MODEL "J"

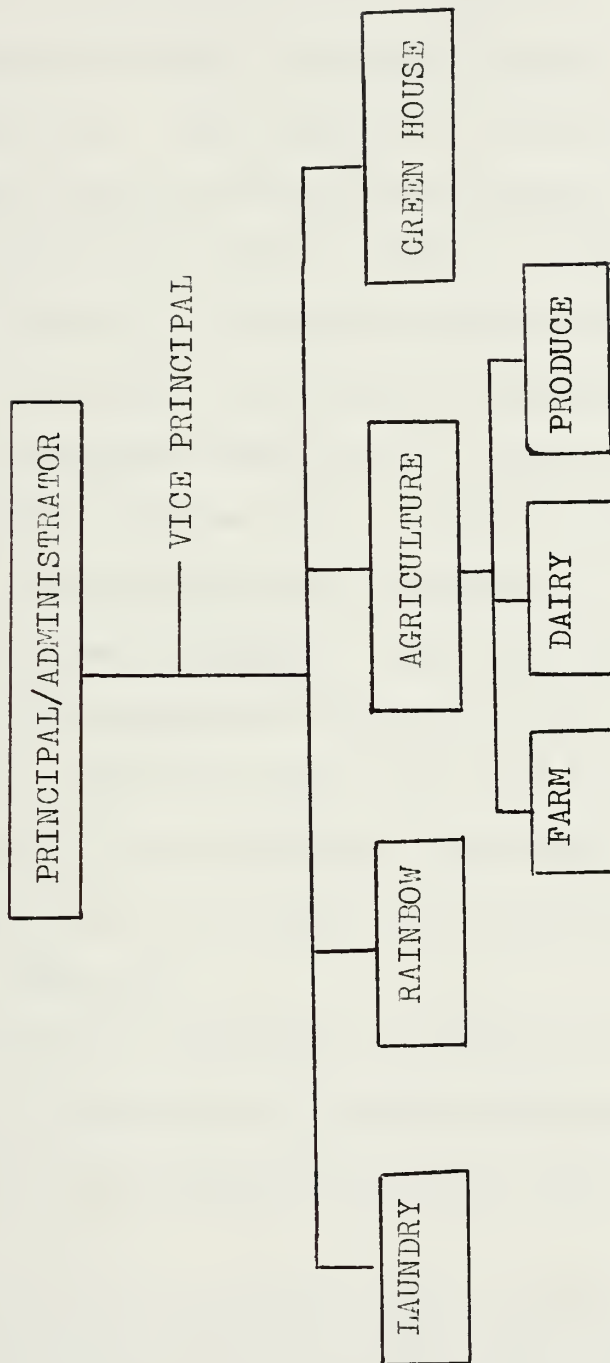
Monterey Bay Academy is a coeducational, boarding high school located on the eastern shore of Monterey Bay in Watsonville, California. MBA was built and is currently operated by the Central California Conference of Seventh-Day Adventists. (Board of Directors) MBAs' central

purpose is to provide a christian education for high school aged youth while at the same time satisfying their physical, mental and spiritual needs.

Approximately 55 faculty and staff have supervision and control responsibilities for five hundred twenty-five students. Students are expected to work at least two hours a day or 40 hours a month. To support their student base with employment, MBA operates an industrial complex of six industrial type activities. During 1979, MBA generated over \$3 million dollars of revenue, approximately half of which comes from the industrial activities. The revenue generated by the industrial activities serves the school in two ways. First, students are able to reduce their tuition cost, and secondly, the industrial activities are able to substantially support the overhead base of the school, thus tuition is much lower than it would be without the industrial activities.

The industrial activities consist of six different divisions: the laundry, greenhouse, dairy, farm, produce and the surfboard fin manufacture. (See Exhibit D) These activities are managed by line-managers with technical expertise in their individual fields. The industrial activities are responsible for approximately \$1.5 million dollars per year in income. Collectively, they have 159

EXHIBIT D
ORGANIZATION CHART FOR INDUSTRIAL ACTIVITIES



total employees, including 20 adults and 139 students.¹ All adults are full-time employees, and all students are part time. Each division is headed by a manager, and all adults serve in some supervisory capacity.

The laundry provides commercial laundry for the Monterey Bay Peninsula area. The majority of their business comes from hospitals and the hotel/motel industry. Their average volume of business is 14,000 pounds of laundry per day. The laundry employs 13 full-time adults and approximately 75 students. In 1979, the laundry's sales volume was \$454,000.

Rainbow (surfboard manufacture) produces approximately 30,000 surfboard fins per year. Rainbow employs two full-time adults and approximately 15 students. Their sales volume for 1979 was \$178,000. The Green House is the newest addition to the industrial complex at MBA. It was acquired in July 1979. The Green House has only one adult manager and approximately five students. The sales figures were not available, but as of June 1980, the Green House had an inventory of \$45,000

The agriculture department consists of three divisions: the dairy, the farm and the produce division. The department is headed by a superintendant who acts as the

¹ The remaining students of MBA work in administrative services, housing, janitorial services, etc. Then another set of students work in cooperative jobs outside of the control of the school. The largest cooperative (Harris Pine Mill) is located on the campus and employs 150 students.

coordinator and department manager. The dairy employs two adults and approximately ten students. Of the 450 cows on the dairy, about 210 are milking cows. These milking cows produce approximately 360,000 pounds of milk and fat per month. The 1979 sales for the dairy were \$400,000.

The farm basically grows crops to support the dairy. It grows and harvests about 2,000 tons of corn silage a year, and 36,000 tons of oats, barley and alfalfa green chop per year. The farm sells its produce to the dairy at the fair market price for these goods on the local economy. Sales volume for the farm in 1979 was \$106,000. The farm employs one adult and four students.

In the past, the produce division has been used to employ those younger students who were not able to work elsewhere. In 1979 their financial statement showed a loss of \$52,000. This year the produce division is being turned around. Through a more selective crop selection and the hiring of large number of students only during the harvesting time, the produce division is projected to lose only \$11,000. Presently, they grow kiwi fruit, raspberries, olallieberries, asparagus, banana squash, acorn squash and zucchini squash. The produce division has one adult as manager and anywhere from four to thirty students depending on the season.

The administrator, Mr Voth, of this institution is an entrepreneur who has eagerly sought out opportunities to

expand his industrial base. Mr Voth is constantly looking for new ways of increasing the work opportunities for MBA students. One reason for this is that Mr Voth places a high value on work experiences for the students. Another reason is because he recognizes the importance of MBA having a strong and well rounded employment base. As costs rise, more and more parents are looking for ways to off-set the cost of their child's education. With the present tuition cost being \$3,800 per year, more parents who desire to send their children to private religious schools are seeking schools that offer their children a strong work program. MBA provides such a program.

The following sections provide the results of the application of the various stages of Model "J"

1. Stage I - Educational Phase

The author (auditor) of this thesis sought and was given permission by the Principal (administrator) of MBA to conduct an audit of the school. The agreement between the auditor and administrator specified that the administrator would be the contact point. The author would also perform the diagnostic portion of the audit and implement as much of the recommendations as practical.

The educational process of the auditor in trying to familiarize himself with the school began as soon as the

thesis topic was submitted and approved. The auditor did not have the resources to contact former employees or members of the Board of Directors. The only source of information about MBA was available from former students and parents of students. All of these persons spoke highly of MBA. Their comments revolved around the value and uniqueness of the school to high school students. None of them knew much about the industrial activities.

During these initial sessions between the administrator and the auditor, other areas of agreement were reached. For example, there was to be no charge for the activities of the auditor, a tentative schedule was proposed for briefing subordinate managers, and methodology for administering the questionnaire was discussed and settled upon. Also brought up during the discussion was the topic of what the scope of the audit should be, and the ground rules of the audit. Because the auditor and the administrator were interested in the industrial activities of the school, emphasis was limited to the industrial complex. Operating ground rules were discussed with the most important being the confidentiality of information supplied to the auditor by the subordinate managers of MBA.

During the initial discussions with the administrator, he briefed the auditor on how he viewed the responsibilities of each division, as well as how the roles of the

industrial activities fit into the organization as a whole. Mr Voth seemed very attuned to the environment at MBA. He was aware of several situations at MBA that needed additional attention, but he was not sure how to attack or handle these situations.

As for the qualifications of the auditor, the auditor's personal and technical qualifications met or exceeded the qualifications outlined in Chapter IV. He has a Bachelors of Science degree with specialization in Business and Behavioral Science. He was working full-time on a Master of Science degree with specialization in Financial and Acquisition Contracting Management. His auditing experience involved several tours of duty as a Supply Officer in the United States Navy. The auditor spent over three years as Supply Officer aboard two different Naval vessels; he conducted internal audits for food service operations, retail operations (including laundry), disbursing and accounting operations and inventory management of as many as 40,000 line items of materials and repair parts. Also during an overseas tour of duty as the Budget/Fiscal Officer for Commander Fleet Air Western Pacific, the auditor was responsible for conducting annual audits for six Naval Air Stations Club facilities scattered throughout the Western Pacific.

Several days after the initial meeting and two separate discussions with the administrator, the Vice

Principal and managerial personnel from each of the industrial divisions were gathered together for their first meeting with the auditor. The purpose of this meeting was to provide the major players with an overview of what an operational audit model was; how the auditor intended to conduct it; what benefit it would provide to MBA and the managers themselves; and why the auditor felt qualified to conduct the audit.

During the presentation, the author introduced the audit questionnaire to be used during the Diagnostic Audit Phase. The author explained the purpose of the questionnaire and requested that the participants feel free to ask questions on any area of the questionnaire that were unclear to them. Initially, the group seemed hesitant to ask questions, but after two questions about how they should respond to certain questions, the atmosphere became more relaxed. Specifically, a few questions were addressed to whether they should answer the questionnaire in terms of their own individual divisions or whether the questionnaire should be responded to in terms of MBA as a whole. As a response, the auditor requested that they answer in terms of their individual divisions. At the conclusion of this meeting, the participants seemed comfortable, at ease and ready to move into the diagnostic portion of the audit.

2. Stage II - Diagnostic Audit Phase

The educational process enables the auditor to enter smoothly into Stage II of the audit model, the Diagnostic Audit Phase. This phase is characterized by the collection and analysis of data. During this phase at MBA, the auditor used two techniques for collecting data. One was a questionnaire and the other was conducting interviews with the division managers.

The questionnaire was designed as a means of singling out "red flare" areas. These areas were to be selectively brought up during the interviews to see if they were worthy of additional attention during the Intensive Audit Phase. Appendix 1 represents a copy of the questionnaire used during the audit. On the same evening as the meeting, the questionnaire was administered and monitored by the auditor. After completion of the questionnaire, each subordinate manager set up a mutual time with the auditor that they could meet for the interview sessions.

The questionnaires were subjectively evaluated by the auditor, and based on his experience and review of financial and management literature, a summary was prepared noting the following questions as those needing further evaluation and study:

- #4 - Are the objectives of your division in line with the overall objectives of the organization as a whole?

- #6 - Is every job in progress reviewed against the schedule every day?
- #7 - Is 85 to 90 percent of all the maintenance work that is done planned and scheduled?
- #8 - Are the expenditures of your organization based on allocations established by a budgeting system?
- #9 - Does your division prepare an annual budget?
- #10 - Is this budget used to control the amount and rate of expenditures?
- #11 - Are you satisfied with the budget approval process that your division goes through?
- #12 - Are budgets modified when conditions change?
- #19 - Do key employees have their own job descriptions and copies of those of their subordinates?
- #24 - Is there a manpower planning document that identifies manpower replacement and additional needs?
- #25 - Does the organization have any kind of formal performance appraisal program?
- #30 - Do you know how the turnover and absentee rates compare with those of other employers?
- #52 - Has your organization or division developed data for considering the possibilities of plant and equipment failures and their costs?
- #76 thru #80 - Five questions that dealt with Risk and Insurance.¹

¹Based on briefings and discussions with the administrator, it was decided that these questions were not applicable to the subordinate managers. Consequently, they were not dealt with any further.

By the end of these sessions, the subordinate managers had increased their level of sensitivity to their divisions and to the organization as a whole. Already striving to do the best job they could do, these sessions seemed to motivate them even more to push their divisions for more efficiency and effectiveness. In fact when the auditor talked about the benefits that a simple cash flow budget would provide for their divisions, the managers seemed eager to know exactly when the auditor would be available to instruct them in this technique.

As was mentioned in Chapter V, the interviewer was supposed to use a number of open ended questions designed to make the managers feel at ease and allow them to freely participate. For the purpose of the audit at MBA, the following open ended questions were posed to each of the interviewees:

- 1) What is your job in this organization? Would you describe it for me?
- 2) What do you think are the biggest problems you face in doing your job?
- 3) What do you think you need personally in the way of training to improve your functioning in your job?
- 4) What do you think are the biggest problems facing the entire industrial complex of MBA?
- 5) What do you think would help the agency to function better?

After these questions were answered and discussed, attention was then given to the "red flare" areas identified in the questionnaire. The focus of these questions revolved around planning and budgeting. Each manager was asked to identify the planning and budgeting process being used in their division.

Earlier during the opening session between the administrator and the auditor, an agreement was made to move straight from the Diagnostic Audit Phase to the Implementation and Assistance Phase.¹ Consequently, after the interview sessions were completed, the auditor prepared a written report of the results and presented the findings and recommendations to the administrator.

The auditor's findings were: (1) Lack of plans and objectives for each department; (2) Only one division used budgetary plans; (3) Too often decisions were made by top management rather than department heads; (4) Little strategic planning for the future was being performed; and (5) Managers lacked an appreciation for financial controls as they concern internal investments. To remedy these findings, the following recommendations were made: (1) Hire a specialist to instruct all managers in a course in small

¹It should be noted that flexibility was one of the designed features of the model.

business management; (2) Re-examine the present accounting system; (3) Hire a full-time business manager; (4) Design an appraisal system based on management by objectives.

(See Appendix 2 for a copy of the report) The administrator's consent was required before the report was discussed with others. With his consent, the auditor released the information in the audit report to the other managers of the MBA industrial activities.

During a collective meeting with all of the managers of the six divisions, the auditor went step-by-step through all of the audit comments and recommendations to ensure that each manager understood the focus and intent of each comment. Questions concerning this report were responded to by the auditor, and each manager was given a copy of the report.

3. Stage IV - Implementation/Assistance Phase

In the recommendations of the report on the Diagnostic Audit Phase, the auditor felt that there were a number of areas that because of his background, he could further assist MBA. He felt capable of drafting a college level course in "Small Business Management." The auditor felt that he should re-examine MBA's accounting system, or assist the managers in preparing plans and objectives. Also, given the time, the auditor felt that a marketing strategy could be developed for Rainbow (Surfboard Fin Manufacture).

However, trying to do these things in a graduate school environment was not practical. As a result, the auditor offered to develop and present a six hour seminar to the subordinate managers of MBA. Upon the administrator's request, a six hour seminar was conducted on Planning/Budgeting. The objectives of the seminar were to expose the managers to a financial and business vocabulary, to instruct and then assist them in formulating a cash flow budget, an analysis of the breakeven point for their industry and a plan for next fiscal year.

The subordinate managers attended the sessions of the seminar on a voluntary basis, and seemed enthusiastic about the material to be covered. The sessions were conducted in a relaxed setting. This facilitated questions and comments from the participants, and the sessions seemed very informative. The six hour seminar was broken into three two-hour sessions. The first session dealt with budgeting. In this session, time was devoted to familiarizing the participants with key financial terms that would be used during the session. It specified the definition, purpose and usefulness of budgets. It also identified those areas of the operating statement that required further clarification on the part of the participants.

The second session dealt with cash flow budgets. Cash flow budgets were introduced by a flow chart diagram

and a step-by-step review of a sample cash flow budget. Comments were made and questions asked of the participants to reinforce the concepts of cash flow budgeting. Afterwards, the participants were asked to prepare a cash flow budget for their individual divisions and bring it to the next class.

The third session was a wrap-up period. After reviewing and commenting on the budgets brought to class, the participants were introduced to breakeven analysis charts. Finally, discussion was conducted on the adverse effects of using a budgetary system. (See Appendix 3 for a course outline)

The results of this seminar are difficult to quantify in terms of financial gains resulting from managers being exposed to this session. However, in the opinion of the author, the managers seemed to have grasped the concepts stated in the objectives. The budgets for each department were evaluated by the auditor and a copy of budgeting statements from the produce division appears in Exhibit E thru G. Just the collection and formulation of the data necessary to put these reports together will increase the management efforts of the managers. It should provide the managers with a different thought process. This new thought process should assist these managers in making more enlightened decisions in the future.

EXHIBIT E

Monterey Bay Academy - Produce Department

Direct Labor Budget

For year ending June 30, 1981

<u>Month</u>	<u>Number of Employees</u>	<u>Hrs/day</u>	<u>Days/wk</u>	<u>Hours per month</u>	<u>Wage</u>	<u>Total</u>
July	2 6	8 8	5 $\frac{1}{2}$ x 4 5 $\frac{1}{2}$ x 4	352 1,056	\$3.25 3.10	\$1,144 3,273
August	2 2	8 8	5 x 4 5 x 4	320 320	3.25 3.10	1,040 992
September	2 28	4 3	6 x 4 6 x 4	192 2,016	3.25 2.60	624 5,241
October	2 14	4 3	6 x 4 6 x 4	192 1,008	3.25 2.60	624 2,620
November	2 8	4 3	5 $\frac{1}{2}$ x 4 5 $\frac{1}{2}$ x 4	176 528	3.25 3.10	572 1,636
December	2 2	3 3	5 x 4 5 x 4	120 120	3.25 3.10	390 372
January	4	3	5 x 4	240	3.25	780
February	4	3	5 x 4	240	3.25	780
March	4	3	5 x 4	240	3.25	780

\$4,417

\$2,032

\$5,865

\$3,244

\$2,208

\$762

\$780

\$780

\$780

EXHIBIT E
(continued)

<u>Month</u>	<u>Number of Employees</u>	<u>Hrs/day</u>	<u>Days/wk</u>	<u>Hours per month</u>	<u>Wage</u>	<u>Total</u>
April	4	3	5 x 4	240	\$3.25	\$780
May	4	3	5 $\frac{1}{2}$ x 4	264	3.25	858
	10	3	5 $\frac{1}{2}$ x 4	660	3.10	2,046
June	2	8	5 $\frac{1}{2}$ x 4	352	3.40	1,196
	30	8	5 $\frac{1}{2}$ x 4	5,280	2.75	14,520
YEAR TOTALS					\$40,268	\$40,268

EXHIBIT F

Monterey Bay Academy - Produce Department Budgeted Income - By Crop for year ending June 30, 1981

<u>Crop</u>	<u>Yield</u>	<u>Unit Price</u>	<u>Total</u>	<u>First Quarter</u>	<u>Second Quarter</u>	<u>Third Quarter</u>	<u>Fourth Quarter</u>
Kiwi fruit	4,200 (lb.)	\$1.00	\$4,200		\$ 1,050	\$ 2,100	\$ 1,050
Raspberries	31,000	1.25	38,750	\$ 6,458	12,916		19,376
Olallieberries	21,000	.70	14,700	3,675			11,025
Asparagus	5,000	.50	2,500			1,250	1,250
Banana Squash	10,000	.05	500		500		
Acorn Squash	10,000	.10	1,000		1,000		
Zucchini Squash	31,875	.08	2,550	1,275	1,275		
TOTALS			\$64,200	\$11,408	\$16,741	\$3,350	\$32,701

EXHIBIT G
Monterey Bay Academy - Produce Department
Budgeted Operating Summary
for year ending June 30, 1981

	<u>First Quarter</u>	<u>Second Quarter</u>	<u>Third Quarter</u>	<u>Fourth Quarter</u>	<u>Total</u>
<u>Income</u>					
Misc non-student	\$11,408	\$16,741	\$ 3,350	\$32,701	\$64,200
Total earned income	11,408	16,741	3,350	32,701	64,200
<u>Expense</u>					
Salary	4,375	4,375	4,375	4,375	17,500
Worker allowance	50	50	50	50	200
Student labor	12,314	6,214	2,340	19,400	40,268
Comp ins/soc sec/sust	1,550	1,550			3,100
Supplies and expense	3,500	750	750	4,000	9,000
Total direct expense	21,789	12,939	7,515	27,825	70,068
Administration	210	210	210	210	840
Catastrophic Med	10	10	10	10	40
Equipment maintenance	400	400	400	400	1,600
Garage	4	4	4	4	16
Grounds	95	95	95	95	380

EXHIBIT G
(continued)

	<u>First Quarter</u>	<u>Second Quarter</u>	<u>Third Quarter</u>	<u>Fourth Quarter</u>	<u>Total</u>
Insurance	\$ 81	\$ 81	\$ 81	\$ 81	\$ 324
Taxes	40	40	40	40	160
Phone	16	16	16	16	64
Water	90	90	90	90	360
Depr. land improv.	35	35	35	35	140
Depr. equipment	506	506	506	506	2,024
Total Operating Expense	<u>\$23,276</u>	<u>\$14,426</u>	<u>\$ 9,002</u>	<u>\$29,312</u>	<u>\$76,016</u>
Net operating p/l	<u>\$(11,868)</u>	<u>\$ 2,315</u>	<u>\$(5,652)</u>	<u>\$ 3,389</u>	<u>\$(11,816)</u>

At this point, the auditor had to disengage for personal reasons. The auditor could no longer provide further assistance, but he did leave the following guidelines to the administrator:

1) Support and actively use the planning data prepared by the division managers. If the administrator does not use the data, it will not be long before the organization returns to a system of every division planning to spend what they spent last year.

2) Allow the seminar to be only a step in the educational process of the subordinate managers, rather than the culmination of training. There is still a great need for the "Small Business Management" course. The six-hour seminar has only heightened the interest of the managers. If the cost of bringing an instructor to MBA is too prohibitive, then consideration should be given to encouraging the staff to take a "Small Business Management" or "Introduction to Business" course at a local community college.

3) Subordinate managers are normally skeptical about the actions proposed to top management. It is common for them to feel that as soon as the auditor leaves, things will merely return to normal. The administrator can change this attitude by providing the subordinate managers with a feedback session on what the organization can afford to do and approximately when the planned implementation will continue.

4) Every effort should be made by the administrator to have decisions made where practical at the lowest level capable of being responsible for the decision made.

5) Set up a timetable for hiring a full-time business manager. It would be nice if the person was capable of dealing with some of the marketing problems of Rainbow. This way Rainbow could expand their market. The surfboard industry appears to be declining, consequently, it is not too early to look into other markets, such as key chains, which will offer a potential method for utilizing scrap. This action alone could mean an increase in annual revenue of \$50,000.

It would be easy for the auditor to suggest that all of these guidelines will be instituted by the administrator, but that would be impractical and difficult to predict. And, if the auditor made a prediction, it could serve to prejudice implementing all or portions of the recommendations. In such a short time after the audit, it is very difficult to measure the success of the audit. Only the implementation of these guidelines will determine the overall impact that the audit has on changing the attitude of the administrator. The problem of dealing with the attitude of the top manager is discussed, with other limitations of the model, in Chapter VII. Even though the audit has been successful in terms of benefiting the subordinate

managers, this success can erode quickly if the concepts the success is based on are not followed through to the finish.¹

C. SUMMARY AND CONCLUSION TO THE TEST CASE

The intent of this chapter was to demonstrate the practical usefulness of "Operational Audit Model "J" in the real-world environment. The application of the model has demonstrated that it can be a useful tool for managers of a small NFP, and inspite of its limitations, it has promise. With some slight revisions and modifications, its overall success could be even further increased.

One of the most relevant contributions the audit model made at MBA was the fact that it upraised the confidence level and morale of the division managers. Previously, there was some concern as to their importance to the organization. The audit process reinforced the fact that the industrial activities were contributing to the school in a very positive fashion, and therefore, the managers should

¹This should not be interpreted as saying all the recommendations will have to be met for the audit to be a success. Subordinate managers recognize that there organization does not have unlimited resources. A simple meeting as described earlier, where the top manager addresses what will be done and what cannot be done, will fulfill the need for having management attention. If this is done, at least the participants know that some thought and consideration were given to using the audit.

be proud of their contributions. The feeling seems to be that if their activities were not that important, then no one would have wasted the time and effort to conduct an audit.

In addition to the upraised spirit of being a positive contributor to the MBA organization, each division manager went away from the audit process with a heightened awareness of the problems and opportunities confronting their divisions. The operational audit provided each division manager with an increase in knowledge in areas of planning, budgeting and provided them with new tools for dealing with their environment. Hopefully, it instilled in these managers a desire to continue to explore other modern management tools that will make them more proficient than before in running their divisions of MBA.

The biggest weakness of the operational audit rests on its built-in weaknesses. Because of a lack of sensitivity or awareness to certain issues or may be as a matter of choice, the audit model has certain built-in limitations. In the next chapter, the author discusses these limitations in a general sense and explains what action an auditor should consider when dealing with them. In spite of these limitations, however, there is no evidence that would lead one to conclude that it is a waste of time, and there is evidence that it contributed significantly to the way the

managers of MBA view their organization. As a result of the operational audit, these managers have gained access to valuable managerial tools that will be useful to them in managing their organization.

VII. FINAL THOUGHTS

Operational Audit Model "J" has been presented; its use and application illustrated and discussed. This final chapter will discuss the limitations of the model and the dilemma facing those individuals with an interest in maintaining the NFP sector as a part of the American economic system.

A. LIMITATIONS OF THE MODEL

1. Confidentiality of Information Difficult to Protect

Because of the smallness in size and limited specialization of certain activities within the different departments/divisions of most small NFPs, it is very difficult to shield the source of certain comments or pieces of information. During the course of the application of the model at MBA, there were numerous times where anyone familiar with the organization could figure out the source of the information on which the auditor based certain comments. Despite this difficulty, the auditor should do everything possible to protect the source of the information collected. Also, during the initial brief with the subordinate managers,

it would be a good idea that the auditor bring up this topic for discussion, thus providing the participants with an opportunity to share their views on the subject.

2. Questionnaire Too Technical

There may be a need to further simplify and tailor the vocabulary of the questionnaire such that it would be easier for the participants to interpret. During the application of the questionnaire, there were several obviously difficult questions. Yet very few of the participants inquired about these questions until the auditor specifically asked the participants if they understood the content of the question. If the language cannot be toned down to a level which laymen will understand, then some type of educational or business vocabulary training session might be recommended before the questionnaire is administered.

3. Model Focuses on Subordinate Managers

The operational audit model presented here places more emphasis on assisting subordinate managers than top managers. In a situation where the problems of the organization rest largely on top management, different techniques than presented here may be necessary in order for the operational auditor to deal with this situation successfully. In the test case presented in Chapter V, training was

directed at the subordinate managers with little attention other than a briefing directed toward the administrator (top manager). This could create some problems. As an example, if the subordinates are ready for a change that top management does not fully support or is not ready to implement, one could expect conflict between the two levels of management. In the case of MBA, this may not be a problem because the administrator appeared to be quite ready to listen to his subordinates. However, in another scenario the results could be different. Therefore, the auditor should be sensitive to this issue, and should come prepared to give further attention to preparing the administrator to accept and assist in implementing the recommendations of the audit.

4. No Specified Time Frame

Model "J" is weak in terms specifying precisely how much time is needed for an auditor to work through the complete model. Approximately two weeks full-time (eight hours a day) could be used as a guide, but it should be discussed with the contact point during the initial brief. Of course, the time frame is directly related to the amount of resources available for the audit. The audit of MBA was conducted in two and three hour segments with large time lags (several days) between sessions and interviews. This may have had an effect on the data collection process for

the test case audit. For example, if the initial meeting has built up the curiosity and interest of the subordinate managers and it takes a week before the managers have their interviews with the auditor, it seems probable that the initial interest level could subside. Consequently, the auditor may find it necessary to go back over some of the comments and discussion from the initial meeting on how this audit process will personally benefit the subordinate manager. Normally this would not be a factor with the auditor working full-time on the audit.

5. Volunteers Not Considered in Present Model

The author recommends that some attention be given to what impact volunteer workers have on a small NFP, and what special considerations or appreciation the auditor must have to adequately evaluate them or their operational impact on the organization. There are approximately 37 million Americans involved in volunteer work in this country. (Selby, 1978). In addition to the other difficulties faced by managers of NFPs, they have the added task of managing and motivating volunteer workers. If the auditor enters an organization with a large proportion of volunteers, the auditor must be sensitive and cognizant of some of the reasons people volunteer to work for NFPs.

- 1) The role of volunteers is normally very different than the role this individual fulfills in other areas of his life. A volunteer is doing something because he sees a need and wants to do something about it.

- 2) This person often acquires a more impressive title, associates with more prominent people, or otherwise achieves a higher status (socially, politically or professionally) through volunteer work than through his other activities.
- 3) The volunteer enjoys a freedom of choice which is not always available in the home or at work.
(Selby, 1978)

Too often, managers are merely satisfied when volunteers show up. Any work performed is "gratis." This type of attitude causes very serious problems for the total organization. In order for auditors in the small NFP sector to be effective, these auditors must be prepared to make recommendations as to how it might be possible for the client organization to make more efficient use of its volunteers.

6. Lack of Accounting and Financial Standards

The lack of accounting and financial indexes make it very difficult for small NFPs to be compared or evaluated objectively. The auditor finds that his evaluation of organizational behavior must be based on a general condition or hunch which is derived from the auditor's previous experience or information from the literature. Unlike the profit sector where you can find financial ratio analysis, Moody indexes, and the like, no such indexes or ratios are available for use in the NFP sector. This affects the model in that it poses the question of how can the auditor prove to the administrator that a particular finding

indicates a problem for the organization. Therefore, the auditor should look for substantiation for the audit findings in the private business sector, and where appropriate, modify the standards to allow for differences in goals and objectives.

7. Current Questionnaire Designed More for Industrial Type of NFP

Questions listed in survey used during the Diagnostic Audit Phase tend to lean heavily toward a manufacturing or industrial type of entity. Given a totally different environment, say, strictly service oriented small NFPs, the present questionnaire would have to be considerably modified. In fact, it would probably be better not to apply a general questionnaire, but to design the unique questionnaire after one knows the type of small NFP being audited. This way the questions could be tailored toward anticipated areas of concern gathered from personal observations of the auditor or comments from the initial contact person.

It is not the impression of the author that these comments render either Model "J" or the data collected during the test case invalid. But these limitations represent areas of concern or points that must be noted and appreciated if the model is going to be used. The potential auditor must be familiar with these limitations, otherwise one might grossly misjudge the data or findings. The auditee

(client) must understand the limitations of this model so that the organizational managers can take these factors into consideration as they decide on whether the amount of return from using this management tool is worth the resources necessary to conduct the operational audit.

B. CONCLUDING REMARKS

This thesis has dealt with a number of the major problems of managers of small NFPs. Problems like poor fiscal management, poor accounting procedures, poor information systems and an inability to comprehend their environment, have cast doubt on the ability of NFP managers to deal with the changing economic climate of America. (Henly, 1976, and Herzlinger, 1979). Operational Audit Model "J" is one method of dealing with a cross section of these problems.

The reader should be reminded that Operational Audit Model "J" was designed to identify problems in various areas such as planning and budgeting, information and communication, personnel, purchasing, inventory control, etc. It was built to encompass a broad knowledge of different managerial functions. Knowledge of these functions allows the small NFP auditor the opportunity to develop a process for solving the current needs of a

small NFP manager, as well as assisting the manager in developing personal skills to handle similar problems in the future. In fact, the effectiveness of the operational audit largely depends on the skills of the auditor to encourage and motivate some NFP managers to use the knowledge and skills acquired during the audit.

In view of this, an operational audit cannot be looked at as a panacea to solve all of the small NFP managers problems. Other techniques and tools will have to be modified and adopted for use in the small NFP environment if managers in this environment are going to be successful.

"Successful" means that these managers would have an appreciation for the need for effective information systems; that they are provided this information on a "real time" basis and as a result, know what is happening in their organization; that with this information system, they would be capable of spotting and solving problems before they get out of hand; and, that, they as managers, have an ability to take the information provided, analyze it, and use it to project effective organizational plans for the future.

With the appropriate tools and techniques, managers of small NFPs are more apt to be successful because they will be better prepared to deal with the changing economic

environment of America. On the other hand, if they fail to accept these techniques and fail to change their present managerial style, then they will be at the mercy of changing economic conditions and value systems; consequently, decreasing their chances of long run success.

From the information presented in this thesis, the author concludes that the operational audit is a very attractive and viable tool available to those small NFP managers who choose to use it. However, not all managers are ready to use an operational audit, or any other type of modern management techniques. One must recognize that the NFP entrepreneur may be different than an entrepreneur in the private business sector.

Assuming that all or at least most of the modern tools and techniques currently being used in the private and public sectors can be modified for use in the NFP sector, how does one get the message to these managers that these tools and techniques are available for their use? And how does one convince small NFP managers to use these tools and techniques once they are aware of their purposes and benefits?

The most logical way to get small NFPs the message that certain tools are available for their use would be to first convince them that they need help. On the surface this might appear to be a simple task, but because of earlier comments on special needs and considerations for dealing

with small NFPs, the author concludes that this will not be an easy task. It will be difficult because small NFPs are not big enough or powerful enough to have consulting firms soliciting them for their business. And even if the small NFPs were sold on the idea of using a consulting firm, with the limited resources of small NFPs, it is doubtful that they could afford their services.

This means that top managers of the small NFPs must recognize that their organizations need help. The manager must know, for example, that the organization needs a special type of operational audit and then be willing and able to go and seek out someone they can afford and who is willing to assist the organization. The author does not pretend to know how to convince someone to ask for something that they are not even aware exists. But somehow, this issue must be dealt with if real progress is to be made in the management of NFPs.

The question of how one convinces small NFP managers to use these tools when they are aware of them creates another dilemma. Now the point becomes, how does the auditor deal with the attitudes of top management? Convincing managers to throw-in their support is a primary factor in effecting positive change in any organization setting. (Beckhard and Harris, 1977). In fact, Beckhard and Harris (1977) call this phase of an organizational

change effort, developing a commitment plan. Their model for organizational transition was designed for large, complex organizations, but in the opinion of the author, it has applicability in this instance to smaller organizations as well. The purpose of the plan is to identify who in the organization must be committed to the change effort, if the effort is actually to take place and to develop strategies for securing their support.

In the instance of the test case, the auditor was able to convince the administrator that MBA was in need of an operational audit, as well as persuade the administrator to approve of and support the operational audit. In another setting, this task may not be as easy. Attention must be directed to the fact that in the case illustration, the audit was performed at no cost to the NFP. Consequently, the motivations for the administrator to accept the audit may be very different than that of a top manager faced with a \$100 a day or more consultant's fee. Given the lack of financial astuteness and the inability to adequately evaluate the opportunity cost associated with whether an audit is worth its cost, it becomes difficult to predict how these managers will respond. Under the condition that MBA would have to pay, a more convincing argument would be necessary than was given during this test case.

Yet another concern for the small NFP environment is the fact that some small NFP managers consider the problems confronting their organizations to be uncontrollable at their level. (Herzlinger, 1979, and Selby, 1978). These managers rationalize and adopt an attitude that they have no control over certain variables so why worry about them. After all, things have gone okay in the past. There might have been problems, but they always seemed to work themselves out before, without an operational audit, so why worry about one now? Why should money be spent for something that the organization has done without in the past?

Or another example stems from managers who feel that their work environment is uncontrollable; the attitude of a manager who feels that the best way to handle the work force is to leave workers alone. This manager does not define the role of management as being responsible for motivating the work force. Because of these managers' perception of the NFP environment, it is very probable that they may feel management of a NFP is very different from management in the private business sector because of the lack of specific and quantifiable objectives such as the profit motive provides for the private business sector.

To further complicate the problem of trying to change the attitudes of small NFP managers is an assumption

adopted by some managers that because their cause is good and honorable, it will sell itself. "Because I know how good the cause is and believe in it, I assume that others will appreciate and understand it as well." (Selby, 1978). So why worry about efficiency and effectiveness, someone will come to the defense of a "noble cause." After all, the NFP sector provides too much public good to be abandoned.

Until managers of small NFPs realize the true value of keeping up with modern business techniques, someone has got to take the responsibility of educating them and then keeping them up to date. Currently, the literature reveals little insight as to ways of handling the issues discussed in this chapter. But, if the NFP managers are to be adequately prepared to meet the economic challenges of the next decade, they must be more appropriately prepared to meet changing social and economic variances. What is needed is more tools adaptable to small NFPs and a way to adequately transfer the technology presently being used in the private business sector such that small NFP managers may share in this knowledge of modern management techniques.

C. A FINAL THOUGHT

In the opinion of the author, based on the information presented in this thesis, the stability of the NFP sector is important, and the downfall or loss of the NFP sector would be a tragedy to the American economic system. The alternative to the NFPs could be too much government, if governmental entities assumed the role previously provided by NFPs; or it could be the takeover of the American economy by big business and multinational conglomerates whose objectives might be very different from those of the NFP entities currently providing the activities in the NFP sector.

APPENDIX 1

QUESTIONNAIRE FOR SMALL NOT-FOR-PROFIT ORGANIZATIONS

This questionnaire is designed to assist small Not-for-Profit organizations in developing a strategy for optimum allocation of the limited resources of the organization, as the organization applies these resources to obtain its goals and objectives. Its intent is to identify "red flare" areas that should be examined in more detail. It is hoped that the in-depth examination would then dictate whether the area being reviewed was truly in line with the overall objectives of the organization or needed adjustment to be so.

This questionnaire was not designed exclusively for any particular organization. It was meant to serve all small nonprofit organizations. Because of this, some areas may not be as applicable to your organization as you feel they should be. In the space below those questions, please indicate "not applicable." If possible, write a short statement of why you feel it does not apply to you, or what alternative is being used in your division.

The information here is principally for the evaluator and should be anonymous where possible. Consequently, it is not required that you place your name on this

questionnaire. However, please keep in mind that this audit can only be successful with your cooperation and support. As such, the accuracy of your responses is paramount to success.

There may be some terms or words used in this questionnaire that you may not be familiar with. If so, the author apologizes in advance for the academic business jargon. Please bear with it and feel free to ask questions of the moderator.

Please feel free to make any comments in the spaces provided or on the back of the sheets if you feel that additional information is needed for the evaluator to adequately analyze your responses.

THANK YOU FOR YOUR TIME.

Planning and
Budgeting

NOT APPLICABLE

NONE

LITTLE

SOME

SIGNIFICANT AMOUNT

COMPLETE

1. Are you familiar with the plans and objectives of your department or division?

NA ☐ 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐

2. Did you participate in formulating these plans and objectives?

NA ☐ 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐

3. Are these plans effective at meeting objectives?

NA ☐ 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐

4. Are the objectives of your division in line with the overall objectives of the organization as a whole?

NA ☐ 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐

5. Has your division accepted the necessity for work schedules?

NA ☐ 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐

6. Is every job in progress reviewed against the schedule every day?

NA ☐ 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐

	NOT APPLICABLE	NONE	LITTLE	SOME	SIGNIFICANT AMOUNT	COMPLETE
7. Is 35 to 90 percent of all the maintenance work that is done planned and scheduled?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
8. Are the expenditures of your organization based on allocations established by a budgeting system?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
9. Does your division prepare an annual budget?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
10. Is this budget used to control the amount and rate of expenditures?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
11. Are you satisfied with the budget approval process that your division goes through?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
12. Are budgets modified when conditions change?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>

Information and
Communication

NOT APPLICABLE

NONE

LITTLE

SOME

SIGNIFICANT AMOUNT

COMPLETE

13. Is the organization dependent upon a large flow of information for current decision making; that is, is the business such that it is dependent on a high volume of accurate decisions?

NA ☐

1 ☐

2 ☐

3 ☐

4 ☐

5 ☐

14. Has the above fact been recognized in organizational design; that is, have decision responsibilities and authorities been structured into particular jobs and have the jobs been strategically located?

NA ☐

1 ☐

2 ☐

3 ☐

4 ☐

5 ☐

15. Do the managers generally feel they are provided with the information they need to fulfill their responsibilities and exercise their authorities properly?

NA ☐

1 ☐

2 ☐

3 ☐

4 ☐

5 ☐

	NOT APPLICABLE	NONE	LITTLE	SOME	SIGNIFICANT AMOUNT	COMPLETE
16. Are communication channels generally free and open; for example, can personnel readily obtain information from the nearest available source without regard to organization or chain-of-command lines?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
17. Do personnel give evidence of knowing the organization's procedures, policies, rules and regulations?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
18. Has the organization collected its procedural and policy documents in readily accessible form -- in procedure and/or policy manuals, for example?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
19. Do key employees have their own job descriptions and copies of those of their subordinates?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>

	NOT APPLICABLE	NONE	LITTLE	SOME	SIGNIFICANT AMOUNT	COMPLETE
20. Do the job descriptions clearly specify major responsibilities and authorities?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
21. Are reviews of position activities made periodically, and are job descriptions updated?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
22. Do senior managers meet with lower levels on a regular basis, formally or informally (lunchtime and so forth)?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>

Personnel and
Administration

23. Are human relations considered as important to the firm as production, selling and other major functions of the business?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
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	NOT APPLICABLE	NONE	LITTLE	SOME	SIGNIFICANT AMOUNT	COMPLETE
24. Is there a manpower planning document that identifies manpower replacement and addition needs?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
25. Does the organization have any kind of formal performance appraisal program?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
26. Are checks made to see that employees generally are receiving adequate instruction to enable them to do their jobs satisfactorily?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
27. Are employees regularly informed as to the state of the business, company needs and future developments?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
28. Is there a uniform and consistent policy of discipline for employee misconduct?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>

	NOT APPLICABLE	NONE	LITTLE	SOME	SIGNIFICANT AMOUNT	COMPLETE
29. Does the organization maintain adequate personnel files; that is, is a record kept for each employee on an up-to-date and comprehensive basis (including all vital data and appraisal results)?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
30. Do you know how the turnover and absentee rates compare with those of other employers?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
31. Are jobs defined to make the fullest use of each employee's abilities consistent with needs of the business?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
32. Are present forms of communication, that is, upward as well as downward, effective?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>

Production and
Operations

NOT APPLICABLE

NONE

LITTLE

SOME

SIGNIFICANT AMOUNT

COMPLETE

33. Are your production activities flexible so that you can react to the variety of circumstances that develop?

NA ☐ 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐

34. Do you have adequate data on costs of operations so that break-even points can be calculated for a variety of individual and simultaneous production runs?

NA ☐ 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐

35. Are your production and related operations capable of providing the quality standards which are important to your customers?

NA ☐ 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐

36. Do you really know what divisions or sections of your operations produce the major portion of profit for your firm?

NA ☐ 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐

Inventory Control
and Management

NOT APPLICABLE

NONE

LITTLE

SOME

SIGNIFICANT AMOUNT

COMPLETE

37. Is materials handling a major activity in the organization? If no, go to question 50.

NA ☐ 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐

38. Do inventory records appear to serve a useful purpose beyond accounting; for example, are they used for purchasing materials or for scheduling production?

NA ☐ 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐

39. Do materials appear to be standing around piled up unnecessarily on the receiving platform?

NA ☐ 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐

40. Are materials moved more often than necessary?

NA ☐ 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐

41. Are there central locator files?

NA ☐ 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐

	NOT APPLICABLE	NONE	LITTLE	SOME	SIGNIFICANT AMOUNT	COMPLETE
42. Do you feel that there are adequate controls for getting received materials to where they are needed in a timely fashion?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
43. What do you feel causes the delay? Please explain below.	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
44. Are there adequate records to trace material from the time of its receipt until it reaches the accountable division or user?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
45. Do adequate procedures exist for handling damaged materials?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>

	NOT APPLICABLE	NONE	LITTLE	SOME	SIGNIFICANT AMOUNT	COMPLETE
46. Do you know the total cycle times needed for inventory replacements, particularly for critical items?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
47. When inventory is ordered, is consideration given to large enough quantities that might result in cost savings? (Economic Order Quantities)	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
48. Are physical inventory checks conducted on an interval basis?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
49. If yes, in your opinion, is this enough?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
50. Does storage space (throughout the organization) appear adequate?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
51. Do you maintain thorough life-time records in accumulated costs for all plant and equipment features?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>

	NOT APPLICABLE	NONE	LITTLE	SOME	SIGNIFICANT AMOUNT	COMPLETE
52. Has your organization or division developed data for considering the possibilities of plant and equipment failures and their costs?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>

Purchasing

53. Is a department or a single organizational unit engaged in purchasing? If yes, prepare a departmental organization chart identifying positions and reporting relationships.	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
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54. If no, is the purchasing function completely decentralized? If yes, identify responsibilities and describe the purchasing system used.	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
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	NOT APPLICABLE	NONE	LITTLE	SOME	SIGNIFICANT AMOUNT	COMPLETE
55. Does the present degree of centralization or decentralization of purchasing appear justified? If no, list reasons why.	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
56. Are there written purchasing policies?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
57. Have purchasing procedures been documented?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
58. Does the purchasing department actively pursue cash discounts?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
59. Does purchasing coordinate with inventory control and production planning in established systematic reorder points, necessary lead time, inventory markers and so forth?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>

	NOT APPLICABLE	NONE	LITTLE	SOME	SIGNIFICANT AMOUNT	COMPLETE
60. Have purchase quantity levels been established in connection with inventory control to assure economic ordering?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
61. Is expediting deliveries a major problem?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
62. Are all purchases delivered to a central receiving location, as opposed to direct delivery to production areas?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>

Cost and Pricing

63. Can your division reasonably estimate the cost of a job or process before it is begun?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
64. If yes, do cost estimates show both hours and dollars?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>

	NOT APPLICABLE	NONE	LITTLE	SOME	SIGNIFICANT AMOUNT	COMPLETE
65. Are actual costs reported? If yes, are they compared with estimates or standards?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
66. Is the cost system used in budget preparation or other forecasting areas?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
67. Does your division know and regularly review its breakeven point? If yes, by product line?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
68. Are the organization's prices less than the prices of its competitors?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
69. If no, are they equal to or higher than competitors' prices?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
70. Does the organization have a pricing policy concerning its general level of prices for each division, such as premium and bargain prices, in relation to competitors?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>

	NOT APPLICABLE	NONE	LITTLE	SOME	SIGNIFICANT AMOUNT	COMPLETE
71. Does the organization monitor competitive prices on a frequent basis?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
72. Is customer order volume a factor in pricing policy?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
73. Is cost-plus the only criterion used to set prices?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
74. Are discounts or other price concessions employed in an attempt to gain volume and maximize overall return?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
75. Are meaningful, timely sales analysis reports prepared for management review and action?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>

Risk and Insurance

76. Does your organization have adequate insurance coverage to meet the inflated cost

	NOT APPLICABLE	NONE	LITTLE	SOME	SIGNIFICANT AMOUNT	COMPLETE
76. (continued) of replacing buildings, equipment, merchandise and other assets of the organization?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
77. Does your organi- zation have adequate public liability insurance?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
78. Are deducti- bles used in your insurance policies?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
79. Are key per- sonnel of your organization covered by life insurance that protects the organization in case of their de- mise?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>
80. Has your organi- zation considered a variety of insurance plans as part of fringe benefits for your employees?	NA <input type="checkbox"/>	1 <input type="checkbox"/>	2 <input type="checkbox"/>	3 <input type="checkbox"/>	4 <input type="checkbox"/>	5 <input type="checkbox"/>

APPENDIX 2

DIAGNOSTIC AUDIT PHASE

Red Flare Areas

This report is intended for the managers of the industrial activities at Monterey Bay Academy (MBA). The information and comments herein are those of the auditor and not the employees of MBA. These comments are made based on data collected during the diagnostic audit phase of Operational Audit Model "J" designed by the auditor to assist small not-for-profit organizations. The comments and recommendations were drawn from a subjective evaluation taken from audit questionnaires, and a series of interviews with the major players of each industrial department of MBA. During this phase of the audit, the auditor observed that any further examination of the industrial activities should include the maintenance department. For even though they do not generate revenue per se, the maintenance department has a tremendous effect on the expenses of all the departments.

A. PROBLEM AREA NEEDING ATTENTION

1. Managers/Department heads do not have the adequate information and tools to perform a superior job. (Superior

job being one where the work was completed in the most efficient and economic fashion.) Why?

a. No Specific and Clear Objectives Exist for each Department. Having an objective of just breaking even is not good enough. Sound objectives should identify what resources will be needed to achieve objectives.

b. Because of a. above, managers have no plan or budget to show what funds will be needed to achieve objectives.

- Each manager needs information that will allow him to determine how much he has to produce or sell to break even during a given period.
- Each manager needs to know what every expense is for his department for every month. (Presently, there is some question as to whether every charge is seen by the manager or his representative before it appears on the monthly statements.)
- Each manager needs a knowledge and understanding of CASH FLOW ANALYSIS. Without this, it is difficult to predict or estimate next months behavior.

c. Too often, decisions are being made by top management rather than the department heads. When this continues to occur in an organization, it becomes difficult to hold the managers accountable for certain goals (even just breaking even) because he has little control of the factors that will enable him to meet the goal of breaking

even. What is needed is a system of where information is submitted from the department up to top management and then some discussion given to whether certain goals are achievable given the resources of the school. For example:

(1) Objectives could be formulated by the departments and submitted for approval.

(2) Budgets could be formulated with the objectives to show what funds are needed to achieve objectives.

(3) Cash flow statement submitted on an annual basis to allow comparison of all departments by top management.

(4) Equipment replacement plan to provide for cyclic replacement of old machinery and equipment.

d. More strategic planning is needed to govern the future prospects of the industrial activities. Someone in the organization should be looking at how the industries should behave in 1985. For example: What amount of funds will be available at that time? If we lose half of the industries, what impact will it have on MBA? How much of the schools overhead is presently being supported by the industries, and will this support go up in the future or will it go down?

e. Every manager and supervisor must keep in mind that the management and administration of a school and a business entity (MBA industries) is totally different. In

a school environment, it is possible to control expenses based on a set monetary limit. In the business environment a manager cannot make money for his concern unless he is willing to spend or invest money. Every plan or need to spend money must be weighed against its ability to generate more money than invested. Consequently, a control system based solely on keeping spending down will not allow a business to reach its potential. Sometimes such a method of controlling funds will slowly strangle a business entity to the point where it will have to cease functioning.

B. RECOMMENDATIONS

1. Train department heads/managers in small business operations by hiring a college professor or specialist to teach a "small business management" course on MBA's campus. These classes should include the concepts of how a small business manager succeeds in our present economic environment.

2. Re-examine the present accounting system to ensure that it gets the right information to the operational managers.

3. Somewhere in the future plan to restructure your organization to include someone as a full-time Business Manager.

4. Provide a schedule for periodic meetings or briefs for the managers of the industry to discuss concerns of general interest to their work needs.

5. Design a total system where managers can be fairly appraised by their ability to meet some objectives set by themselves and top management.

6. In the short run, investigate expanding Rainbow and the Laundry operations. Rainbow with the right type of assistance could increase its revenue by at least \$5,000 next year. What would be needed is a total utilization approach to its scrap and someone hired or contracted to develop a marketing strategy for marketing key chains. (It would not be appropriate or feasible to expect the present manager to devote his technical expertise towards this type of venture alone.)

If the decision is ever made to increase the opportunity for student employment, then there should be a plan to expand current Laundry facilities and plant.

To assist in the implementation of these recommendations, the auditor has offered MBA an abbreviated (six hour) seminar on planning/budgeting and cash flow analysis. For further assistance, I am available to assist any of the managers on the subject matter of the seminar. (Telephone: 408-372-4168) If serious attention is given to these

recommendations, and funds are expended for these purposes, the school should be able to increase its income by at least a quarter of million dollars over the next three years.

AUDITOR AND DESIGNER OF MODEL "J"

JOHNNIE JOHNSON III

APPENDIX 3

SESSION I

Budgets: Tools of Planning and Control

Introduction

- A. Scope and purpose for seminar.
- B. Motivation for managers of MBA.
- C. Objective: Preparation of a projected cash flow budget or operating statement.

Key Financial Accounting Terms

- A. Participants give a list of 127 terms.
- B. Those terms applicable in cash flow budgets and break even charts were reviewed in class.

Definition of a Budget

- A. Comprehensive.
- B. Coordinated.
- C. Plan.
- D. Financial terms.
- E. Applying to certain operation.
- F. Using certain resources.
- G. Specified Future period.

Purpose of a Budget

- A. Facilitates managerial functions of planning and control.
- B. Gives the responsible manager a guide to the conduct of operations and a basis for evaluating actual results.
- C. Efficient allocation of the capital available.

Framework for Budgeting

- A. The budget period.
- B. Environmental factors.
- C. Social factors.
- D. Economic factors.
- E. Political factors.
- F. Company policies.

Following the lecture on budgets, the participants were required to identify those areas of their operating statements that were unclear. The auditor offered the suggestion of breaking certain large general areas, such as supplies and expenses, down into smaller components. This required the participants to go to the accounting office and inquire concerning the lot of expenditures lumped under supplies and expenses; also, it required the participants to inquire about the indirect expenses billed to their departments for such things as grounds, admin, garbage, land improvement, etc. The purpose of this exercise was to force the participants to be familiar with all expenses charged to their individual departments.

SESSION II

Cash Flow Budgets

Introduction

- A. Questioned participants on what they learned from the accounting division about their expenses.

- B. Purpose of cash flow budget.
- C. Benefit and motivation for managers to learn this technique.

Flow Diagram Chart of the Movement of Cash Into, Through and Out of a Business

Step-by-Step Review of a Sample Cash Flow Budget

At the end of the cash flow budgeting session, participants were asked to bring a cash flow budget representing their individual departments for the next session. Questions were posed to the participants to try to see if they understood the concepts of cash flow budgets.

SESSION III

Wrap-Up

Introduction

Examination of Budgets

Review of Breakeven Charts and Breakeven Points

Discussion of Using Data in Cash Flow to Prepare Future Plans

- A. Projected operating statement.
- B. Plans and objectives for near term future in financial terms.

Difficulties in Using Budgets and Plans

- A. Environment where top management appreciates.
- B. Expect resistance from others who do not use plans.

- C. Managers must continue to use for personal decisions even when others do not use as a decision tool.
- D. May have to train others either below managers level or above managers level.

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